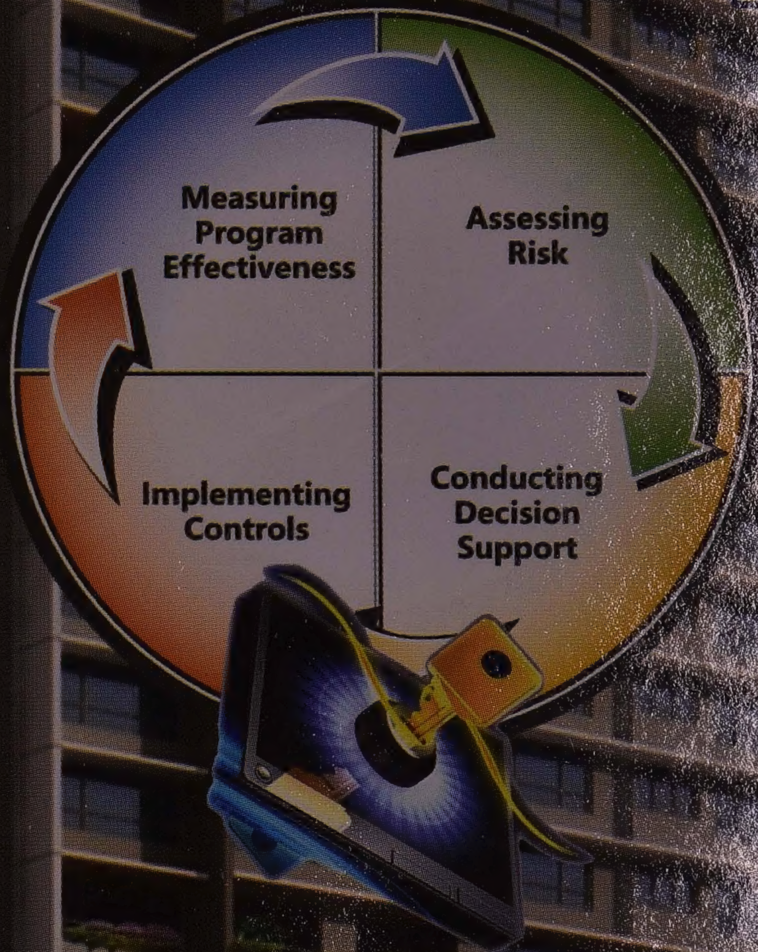
MADURAI KAMARAJ UNIVERSITY
(University with Potential for Excellence)

M.B.A.
Second Year
IV - Semester



Elective VII - Banking

BANKING ASSURANCE & RISK MANAGEMENT

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SYLLABUS

BANK ASSURANCE & RISK MANAGEMENT

UNIT 1: Bank assurance concept, Frame work and Implementation Bank assurance in India, Bank assurance- A Business Sourcing Model to Indian Banks, The Emerging Structure of Bank assurance in India

UNIT 2: Bank assurance in India – An emerging concept: Bank assurance: Challenges and Opportunities in India: Training A critical component for bank assurance in India HR and Operational Challenges in Bank assurance – Indian Perspective.

UNIT 3: Making Bank assurance really work: from product oriented – cross selling to customers focused- cross buying

UNIT 4: New Trends in World Bank assurance: Europe and Bank assurance: A work in progress, Bank assurance in Japan – Opportunity or Threat? Development, growth and current scenario of Bank assurance in middle east region

UNIT 5: Nature and History of Insurance Business- Insurance business in India – Social security tool – Insurance and Economic Development – IRDA – Entry of private players into insurance business – Actuarial profession.

UNIT 6: Principles and Legal aspects of Insurance – Principle of insurable interest – Principle of utmost good faith - Principle of indemnity - Principle of Subrogation – Doctrine of proximate clause – Traffic advisory committee – Legal aspects of life assurance – Indian Contract act – Legal aspects Non –life Insurance.

UNIT 7: Life Insurance – Features –LIC of India – Products - Calculation of premiums – Surrender value – Mathematics of life Insurance Morality tables, Risks Premium , interest table, premium Calculations – Factors determining premium .Extra premium Actuarial aspects – Term assurance annuities – Group insurance and pension plans – Health related insurance – Claims settlement.

UNIT 8: Non Life Insurance – Fire insurance – Standard fire policy Marine – Cargo and Hull insurance – Types. Motor insurance. Liability insurance, Types of policies ; Engineering insurance. Electronic equipment insurance, Burglary insurance – Underwriting practices – Claims settlement.

UNIT 9: Risk Management Process – Risk identifications Perception of risk, Threat a analysis, Event analysis, safety Audit – Risk Evaluation – Concept of probability – Statistical methods of risk evaluation – value of Risk (VaR)

UNIT 10: Risk Management Methods – Contingency Planning – Risk Transfer – Captive Insurance agreements – Reinsurance – Catastrophe covers – Legal Aspects of Reinsurance – Reinsurance markets – Legal Aspects of Reinsurance – Reinsurance markets – Lloyds markets.

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CONTENTS

UNIT 1

BANK ASSURANCE CONCEPT

NOTES

UNITS STRUCTURE

CHECK YOUR PROGRESS

1. What is the extent of development of insurance in India?

1.1.INTRODUCTION

Bank assurance is seen by many to be a significant or even the primary channel.

The banking & Insurance industry have charged rapidly in the changing and challenging economic environment through out the globe. In the competitive & open environment each & every one wants to do better than others. And they know that if they are not able to provide better service the won't survive in Industry. Insurance companies are also to be competitive by cutting cost & serving in the better way to customers. Now the time has come to choose and adopt appropriate distribution channel. The insurance Industry has indeed awakened to deregulated environment in which several private companies have partnered with multinational insurance companies. Despite a billion of population, India still has a low insurance percentage of 1.95 and it is in 51st position in world.

Despite of the fact that India boosts a saving rate around 25%, less than 5% is spending on insurance.

DEFINITION

The sale of insurance and other similar products through a bank. This can help the consumer in some situations; for example, when a bank requires life insurance for those receiving a mortgage loan, the consumer could purchase the insurance directly from the

bank. Some critics feel that banc assurance gives the bank too much control. Banc assurance is not legal in all countries, but it is legal in the United States

Banc assurance, known as Alfinanze and most popular in Europe is the simplest way of distribution of insurance products through a bank distribution channel. It is basically selling insurance products and services by leveraging the vast customer base of a bank and fulfill the banking and insurance needs of the customers at the same time. It takes the various forms depending upon the demography, economic and legislative climate of the country, while demographic climate will determine the kinds of insurance products, economic climate will determine the trends in terms of turnover, market shares etc, legislative climate will decide the periphery within which banc assurance has to operate. The motives behind banc assurance also differ. For banks it just acts as a means of product diversification and additional fee income; for insurance company it acts as a tool for increasing their market penetration and premium turnover and for customer it acts as a bonanza in terms of reduced price, high quality products and delivery to doorsteps. So every body is a winner here.

1.2. BANK ASSURANCE IN INDIA

Banc assurance commonly means selling insurance products under the same roof of a bank. Though banc assurance had roots in France in the 1980s, and spread across different parts of Continental Europe since, it has spread its wings in Asia – in particular, in India. In India, there are a number of reasons why banc assurance could play a natural role in the insurance market. First, banks have a huge network across the country. Second, banks can offer fee-based income for the employees for insurance sales. Third, banks are culturally more acceptable than insurance companies. Dealing with (life) insurance, in many parts of India, conjure up an image of a bad omen. Some bank products have natural complementary insurance products. For example, if a bank gives out a home loan, it might insist on a life insurance cover so that in case of death of the borrower, there is no problem in paying off the home loan. Similarly, a car loan could only be given if comprehensive auto insurance is taken out on that particular car.

EXPANSION OF BANKS IN INDIA

Penetration of commercial banks in India has been quite extensive. There are around 66,000 branches of scheduled commercial banks. Each branch serves an average of 15,000 people. The only other national institution with a bigger reach is the postal service.2 Banks have not only been successful in the urban areas. It has also grown tremendously in the rural areas. Of the total number of branches of commercial banks, there are 32,600 branches in rural areas, and 14,400 semi-urban branches. In addition, there are 196 exclusive regional rural banks in deep hinterland. There is research evidence to show that the deliberate expansion policy of banks in rural areas has contributed to poverty reduction in India. Instead of simple headcounts, if we take other bank penetration measure like total value of deposits as a percent of GDP, it is also exhibiting an upward trend. This means bank deposits are growing at a rate much faster than the gross domestic product. The Department of Posts (DoP) has 155,600 branches all across the country. Oriental Insurance has set up ties with the post offices to distribute their products on a pilot basis

1). Banks have become the main saving vehicle in the economy. Between 1985 and 1995, the growth of deposits in banks stalled at under 35% of the GDP (that itself is a high number by the standard of the developing economies). From 1995, the banking sector started growing again. The deposits in banks grew another 10% of GDP by 2000. This level of growth in bank deposit has been totally unprecedented in India since independence. Why did the bank deposits take a leap? One simple (but partial) reason is a substitution from the stock market. In 1994, Indian stock market was hit by the worst scandal of manipulation of stock prices in its long history. The stocks fell sharply driving many investors into safer investment options. Rising saving *rate* during the late 1990s led to sustained growth of bank deposits that is, additional investment in the stock market came in the form of fresh money and not a flow of money out bank saving. The rising saving came as a result of rising income across the board. With this background, it is therefore not surprising that banks have become a vehicle for selling insurance products.

FINANCIAL INSTITUTIONS IN INSURANCE BUSINESS: RBI RULES

NOTES

Banks are regulated by the Indian central bank, the Reserve Bank of India (RBI). Therefore, the RBI has set down the rules for the entry of banks in the field of insurance. In 1999, the Governor of the Reserve Bank of India declared: "Presently, there is no provision in the Banking Regulation Act whereby a bank could undertake the insurance business. The Act may have to be amended before banks could undertake insurance business. Alternatively, there is a provision in the Banking Regulation Act whereby banks could take any other form of business which the central government may notify. Thus, if the central government notifies insurance business as a lawful activity for a banking company, perhaps banks would be able to undertake insurance business. It may, of course, be necessary to specify what type of insurance business they could undertake". However, the following year, in a set of draft guidelines issued to all scheduled commercial banks and select financial institutions, the RBI laid out a set of parameters that need to be met. (1) The net worth of the bank/financial institution should not be less than Rs.5 billon. (2) The capital adequacy ratio of the bank/financial institution should be not be less than 10%. (3) The bank/financial institution should have track record of at least three continuous years of profits. (4) The level of net Nonperforming Assets should be 1% below the industry average. (5) The track record of performance of existing subsidiaries of banks/financial institutions should be "satisfactory". The capital adequacy ratio of the NBFC (applicable only to those holding public deposits) should not be less than 12 percent if engaged in equipment leasing/hire purchase finance activities and 15 percent if it is a loan or investment company. Second, the level of nonperforming assets should be no more than 5 percent of total outstanding leased/hire purchase assets and advances.

LONG TERM DRIVERS OF BANCASSURANCE IN INDIA

The staffing problem has redirected some banks to bancassurance and so has the reduction of bad loan problem. But, they are not the long term drivers of bancassurance in India. The long term drivers in India are going to be the following. (1) The culturally more acceptable banking transactions. Banking does not have the same stigma that (life)

insurance carries (1). This factor will diminish in importance over time as people become more educated. (2) Banks can offer fee-based income for insurance sales. As might be expected, this action has been challenged in the courts by the workers who want to leave. This can be attractive under current rigid structure of wage benefits. At present, banks are prohibited from offering commission to the bank employees for selling insurance products. Banks have found ways to circumvent the problem. For example, they offer "car allowance" for the employees selling insurance. (3) Narrowing bank margins are another key driver. (4) Banks have complementary products with insurance products such as the auto insurance, home insurance or annuities. (5) When the pension reform is undertaken (and it is in the works), banks can become natural institutional vehicles for private pension products. In some countries, banks are explicitly prohibited from selling pension products (e.g., Australia). In some other countries, banks are the leading private pension providers (e.g., Mexico). (6) Healthcare insurance sector can also benefit from bancassurance. In India, only 2.5 million people have access to healthcare facilities. On the other hand, 5% of personal income is spent on healthcare. Banks can distribute and facilitate administration of healthcare insurance. (7) In many countries, the absence of banks from selling insurance seems to stem from regulatory reasons. In India, privatization of the insurance sector signaled an accommodating approach from both the

insurance regulator and the banking regulator for banks entertaining the thoughts of selling insurance.

1.3. BUSINESS SOURCING MODEL TO INDIA BANKS

On December 28, 2000, the State Bank of India (SBI) announced a joint venture partnership with Cardif SA (the insurance arm of BNP Paribas Bank). This partnership won over several others (with Fortis and with GE Capital). Many experts in the industry have awaited the entry of the SBI. It was well known that the SBI has long harbored plans to become a universal bank (a universal bank has business in banking, insurance and in security). For a bank with more than 13,000 branches all over India, this would be a natural expansion. In the first round of license issue, the SBI was absent. There were several reasons for this delay. First, the SBI was seeking a foreign partner to help with new product design. Second, it did not want the partner to become dominant in the long

run (when the 26% foreign investment cap is eventually lifted). It wanted to retain its own brand name. Third, it wanted a partner that is well versed in the universal banking business. This criterion ruled out an American partner where underwriting insurance business by banks has been strictly forbidden by law (although with the passage of the Gramm-Leach-Blily Act, this is not quite as drastic as before). Cardif is the third largest insurance company in France. More than 60% of life insurance policies in France are sold through the banks. Fourth, the Reserve Bank of India (RBI) needed to clear participation by the SBI because in India banks are allowed to enter other businesses on a "case by case" basis. The SBI entry is groundbreaking for several reasons. This was the first for an Indian bank to enter the insurance market.10 Second, even though the regulators have said that banks would not (generally) be allowed to hold more than 50% of an insurance company, the SBI was allowed to do so (with a promise that its share would be eventually diluted). Ever since the entry of the SBI, a number of other insurance companies have declared their desired banking partners. In this process, both life and nonlife companies have tied up with banks. The list of partnerships is in Table 2. Note that some of the partnerships listed here are simply at the Memorandum of Understanding (MoU) stage. This kind of synergy between a bank and an insurance company is not so rare in other parts of the world, but in India, it was.

They are yet to take any concrete form. These alliances are listed in Table 2. A number of interesting facts emerge from the table. The first obvious feature of Table 2 is the "natural partnerships" in the list. Specifically, HDFC Life Insurance is tied with HDFC Bank, ICICI Prudential with ICICI Bank and so on. The second striking feature of the table is the proliferation of banks partnering with single insurance companies. Given that there are only two dozen insurance companies and hundreds of banks, this outcome is to be expected. Moreover, insurance companies are targeting different market segments by affiliating with banks that do niche banking. Take the example of Aviva. Aviva has evolved a three-layered strategy. The first layer is a tie-up with ABN Amro and American Express. It caters to high net worth urban customers. The second layer is a tie up with Canara Bank. Through this nationalized bank with 2,400 branches, it reaches customers across the length and breadth of the country. The third layer, at a regional level, a tie-up with Lakshmi Vilas bank focuses on the region specific customers. This

tie-up helps them reach customers in rural and semi-urban centers in Tamil Nadu and Andhra Pradesh. The third feature is best illustrated by an example. Allianz Bajaj does not have the same banking partners for the life sector as in the non-life sector. These two lists do not match. The same is true for several other companies. Fourth, some banks appear to have tied up with several insurance companies. For example, Citibank appears in the list of a number of life as well as in the non-life insurance company lists. This fact will become important as the warning of the RBI that banks "should not adopt any restrictive practice of forcing its customers to go in only for a particular insurance company" become an issue in the future. Fifth, the most recent addition to the list is the Oriental Insurance Company. In January 2004, it declared that it would distribute insurance policies through the post offices after it announced a joint venture with the Department of Posts. Given that the post offices have unprecedented reach around the country with 155,600 branches, it could distribute policies to the customers even in very remote areas. The Department of Posts is the *only institution* with a reach bigger than the banks in India. There are several other banks in the pipeline for the approval of the IRDA. They include the Punjab National Bank, the Principal Group and Vijaya Bank. Two of them are well-established banks in India. The Principal Group, an international financial institution, is mainly in pension business around the globe. In India, it is likely to enter in a partnership with a bank with national distribution network in order to ramp up pension products once pension becomes deregulated in India. The latest group to receive an outright charter for operating insurance operation is Sahara Group (on March 5, 2004). Sahara's entry is notable for two important reasons. First, Sahara is the only company to enter the Indian market without any foreign partner. It thus becomes the only purely domestic company to be granted a license to operate in the insurance sector. Second, it operates the largest Non-Bank Financial Company in India. It has over 50 million depositors. To put it differently, one in every 20 Indians has an account with Sahara. It serves the country through 1,700 establishments. Since the company is diversified,11 it can use multiple channels for distribution of its product – not the least through its NBFC capacity.

CHECK YOUR PROGRESS

2. What is the extent of development of insurance in India?

1.4. THE EMERGING STRUCTURE OF BANK ASSURANCE IN INDIA

Banking habits: Bancassurance tends to have greater influence where Banking habits are well entrenched. In Continental Europe, good examples can be found in countries like France, Belgium, and the Netherlands. Customers there visit their banks more frequently than in other countries. In other markets, where securities markets dominate, bank assurance developments have been relatively mute.

These also happen to be countries with English Law origin: Australia, Canada, United Kingdom and United States. However, it is not just those countries where bank assurance has not taken large market share in Continental Europe. This is probably driven by restrictive regulatory regime.In India, banking is well spread both geographically and across different socioeconomic groups.

In this respect, India is similar to Continental Europe. India also owes its legal origin to the English system. Thus, it shares some of the characteristics of the other Commonwealth countries mentioned above. In addition, ownership of equity is relatively high compared with the level of economic development. So far, regulation both by the IRDA and the RBI has been accommodating. *Extent of development of insurance:* Where insurance is underdeveloped with low penetration, but there is a strong banking branch network, insurers often use the banking reach as a cheaper alternative to building from scratch. This has been the experience in southern Europe (e.g., Spain, Italy). On this count, India comes out as a mixed bag. There are over 1,000,000 insurance agents in India. Therefore, it does not appear that India *has to* have an alternative distribution system. However, the average number of transactions conducted by these agents is very low (by international standards). A large proportion of them do not have access to telephones or electricity, let alone computers. For some companies, turnover of agents has become a disaster. Banks have more resources in these regards. Thus, banks could provide cheaper service (especially for simple products). In other words, large market like India can sustain serving different market segments through different channels of distribution.

Role of distribution system: In some countries (e.g. Germany & Japan), companies have cross sharing holding arrangements which assign separate roles to the branch

network and the tied agency network. In India, cross-holding is practically non-existent for regulatory reasons. Thus, this element is not very important.

Tax and pension structure: Regulatory advantage - creation of products classed as life insurance. For example, endowment type life policies have been sold extensively in France. But they are closer to long term bank deposits rather than "true" insurance products. Tax structure in the country may encourage this type of products as well. To some extent, this is also true in India. On maturity, payments are tax-exempt. There is also a small tax relief for premiums paid in certain kinds of policies. However, we have to keep this point in perspective. The proportion of workers who pay taxes is very small (in the single digit). Therefore, the tax advantage does not apply to a vast proportion of the population. Similarly, pension is virtually non-existent in India (with the exception of workers in the government sector). Thus, this discussion is academic in India. However, in future, as the economy grows and becomes formalized, this point will assume greater importance. There are various models through which bank assurance operates internationally. In the so called integrative model, branch bankers themselves directly sell insurance products. In the specialist model, specialised personnel of the bank or the insurance company have specific knowledge and training of insurance to sell these products Bank assurance could operate through 'strategic alliance' models involving a simple 'marketing' tie-up or through 'full integration' where the bank sells insurance products under its own brand and undertakes all other functions associated with insurance. In India, this scheme, until now, operates largely through strategic alliances or joint ventures. Under RBI regulations, the maximum equity that a bank can hold in JV with an insurance company is 50 per cent, subject to the fact that bank has a net worth of Rs 500 crore, its Capital adequacy ratio is 10 per cent or more and has a reasonable level of non performing assets. The insurance Regulatory and Development Authority also sets guidelines regarding eligibility of corporate agents. Banking personnel who sell insurance products have to satisfy the same training and examination requirements as insurance agents.

INDIA: AMERICAN VERSUS EUROPEAN MODALITIES

Looking forward towards 2020, with a more developed middle income economy, India will have a bigger insurance market both in life and in non-life. There are two

Estimates vary how large the insurance market will be in 2020. It could be somewhere between USD 120 billion to USD 160 billion assuming no sudden policy reversals by Indian government. developed country modalities that India might move to: the Continental European Model and the American Model. Where is India headed? The short answer: India is moving towards the Continental European model. Why? The peculiar structure of the American model is an outcome of longstanding firewall between banks and insurance companies and a prohibition of expansion of business for both insurance and banks across state lines. This overhang is absent in India. Take the example of insurance business. There is no state by state limit of insurance business. There are minimum business requirements for rural areas. The fragmentation of both insurance and banking businesses in the United States is a direct result of the Glass Steagall Act of 1933. Nevertheless, it might be instructive to examine what succeeded in America for the expansion of bancassurance business. A survey by LIMRA identified the following ten elements for success of bancassurance: (1) Strength of the Brand. (2) Sales Staff Management/Training. (3) The Branch Network/Geographical Coverage. (4) Bank and Insurance products form a complementary range. (5) Single view of the customer. (6) Focus on Customer Service/satisfaction. (8) Use of Customer Relation Management Tools and Techniques. (9) Integration of the bank and insurance organizations producing a single culture. (10) Providing advice/solutions, not selling products (taken from the presentation of Marielle Theron at the SwissRe India CEO Summit, 2003).

There have been two broad classes of agreements between banks and insurance companies. (1) Pure Distribution Agreements. Under this class, there are two sub-classes of arrangements: (1a) Referral Arrangement and (1b) Corporate Agency Arrangement. (2) Joint Venture Agreements. There has been a range of such arrangements from loose to integrated form of distribution partnerships. There has been a substantial growth of bancassurance in India. Within two years, the share of bancassurance in the insurance distribution business has gone from zero to 20% of new business in the private sector. Some experts are predicting that within a decade, this proportion could rise to 35% to 40%. There is evidence that policies sold through bancassurance add more value. In the July 2003 issue of the Asia Insurance Post, the Mr. P. Nandagopal of Birla Sun Life was quoted as saying, "The average size of the policy for the agency channel is Rs 19,500 per

policy and for the bancassurance channel it is Rs 39,000 per policy." Although such concrete numbers are not available industry-wide, there is general consensus that bancassurance is indeed bringing in customers of higher value.

1.5 ANSWERS TO CHECK YOUR PROGRESS

1. There are over 1,000,000 insurance agents in India. However, the average number of transactions conducted by these agents is very low. Banks have more resources in these regards. Thus, banks could provide cheaper service.
2. There are over 1,000,000 insurance agents in India. However, the average number of transactions conducted by these agents is very low. Banks have more resources in these regards. Thus, banks could provide cheaper service.

1.6 REVIEW QUESTIONS:

1. Define bank assurance.
2. What is the extent of development of insurance in India?

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CHECK YOUR PROGRESS

1. Why is the prospect of bank assurance bright in India?

UNIT 2

BANK ASSURANCE INDIA-AN EMERGING CONCEPT

2.1.INTRODUCTION

In India the concept of bancassurance appears to be gaining ground quite rapidly both through commission based arrangements and joint ventures between banks and insurance companies. Banks, too, have in the recent past adopted this strategy both in India as well as internationally. They have moved away from the classical model of deposit taking and credit disbursal through their branch networks and have begun to offer a wide range of products and services like security broking facilities and mutual funds. This is the phenomenon of 'universal banking' that builds on the principle of leveraging existing networks to broaden portfolio offerings. Change in regulatory regimes has also facilitated this diversification. The famous Glass Steagall Act in the US that restrained bans from diversifying into related areas was effectively rendered obsolete by the late 1990s. This diversification of banking services has been driven by a number of factors, all of which have threatened bank profitability.

BANCASSURANCE IN INDIA

After First Narasimham Committee report, Indian banking system gone through huge reforms like merchant banking, lease and term finance, capital market / equity market related activities, hire purchase, real estate finance and so on. Few years back banks of India entered into another financial instrument that's Insurance.

Let's have a quick look on Indian insurance market as at end-March 2006, among the life insurers, there were 15 companies in private sector and Life Insurance Corporation of India (LIC) was the solitary public sector company. Among non-life insurers, 9 companies were in private sector and 4 companies were in public sector as regarding the present size of the insurance market in India, it is stated that India accounts not even 1% of the global insurance market. According to various studies, in India LIC done exceptionally very good job but its able to insured 25-26% of insurable population.

Thus in a country with more than 1.2 billion population, the penetration ratio was 4.8% by end of march-2006 which was far less than world's penetration ratio (7.5%). It also indicates that a vast majority of population remain outside the reach of the insurance, especially in rural and semi-urban areas, in the context of the absence of social security schemes.

In year 2004, due to these vulnerable statistics, IRDA introduced an additional channel of distribution in way long traditional distribution model of Insurance industry called Bancassurance.

The prospects of bancassurance in India is really bright because of following reasons:

- Indian economy is growing with 9% of growth rate.
- Increasing PPP (purchasing power parity).
- Huge inflow of FDI.
- Expansion of middle income class Indians.
- Huge banking infrastructure across urban, semi urban & rural India.
- BASEL NORM-II (2009)

DIVERSIFICATION

Banks have felt the need to offset these through growing fee incomes particularly from the retail side. To target the retail segment, banks have felt the need to offer a more diversified product range to appeal to a diverse range of risk profiles. On the other hand,

stand-alone financial product providers (NBCs, mutual funds etc.) have faced crippling distribution costs that in the face of growing competition, they have not been able to pass on as 'load' on this product. Thus as far as banks and other financial services providers are concerned, there has been a 'double coincidence' of needs that has led them to collaborate either through direct equity participation or ownership by banks or strategic alliances. One of the more recent examples of financial diversification is 'bancassurance', the term given to the distribution of insurance products through branches or other distribution channels of banks. The concept that originated in France now constitutes the dominant model in a number of European countries. In France 70 per cent of new business premiums come through this distribution channel, 69 per cent in Portugal, 63 per cent in Spain and so on. Projections by insurance giant Aviva peg the distribution share of bancassurance at 33 per cent by 2010, making it the single largest distribution channel. In Asia, the share of this network is small but growing rapidly. In China for instance,this accounts for more than 20 per cent of the urban market in insurance in 2003. (It is, however, interesting to note that in some countries bank regulations prohibit bancassurance and it is this regulatory diktat rather than conscious strategic choice that has harnessed the growth of this marketing channel.) In India the concept of bancassurance appears to be gaining ground quite rapidly both through commission based arrangements and joint ventures between banks and insurance Companies. According to the SBI Life insurance estimates, about 15 per cent of the gross premium of new insurance players in financial year 2003 came through bancassurance.

IMPACT ON RETAIL CUSTOMER

While banks and insurance companies stand to gain, what impact does it have on the retail customer? Retail saving choices are getting increasingly complex internationally and Idea is no exception. There is growing need for more divers instruments and avenues of investment. This coupled with need of integrated financial 'one stop shops' to reduce the transaction costs associated with diversification. Globally, insurance products are a major internment savings and this is likely to be the case in India as well as insurance penetration gathers steam. The issue of building brand equity is critical for new entrants into the insurance market. However, tying up with a bank might

NOTES

provide counter-productive if this objective is to be achieved. A number of surveys in the European market have shown, for instance, that in bancassurance partnerships, it is the bank's rather than the insurers brand that dominates and insurance brands often get stifled. The issue of integrating the bank's IT and other support systems also needs to be emphasized. if these are not dovetailed, the possibility of serious systems failure becomes real. Often this issue is relegated to the background and the obvious synergies between banks and insurers get more than their due emphasis. The cost reduction is the corollary of a sharp rise in the numbers of policies sold per employee that follows from enhanced customer access that bancassurance fosters. Bancassurance addresses twin needs of portfolio diversification by retail customers and integration of marketing.

THEME

Bank could charge an artificially low premium for an insurance product and subsidize it through a relatively high charge on say a credit card. This form of 'bundling' not only impedes transparency of pricing but could also lead to 'unfair' advantage for banks offering bancassurance vis-a-vis stand-alone insurers. This might warrant regulatory intervention. Thus, while bancassurance does provide an apparently viable model for product diversification by banks and a cost-effective distribution channel for insurers, there are some potential areas of conflict between the two that need to be ironed out. The success of the partnership between the two entities depends on the right' model' partnership. It is vital for this model to ensure that banks remain fully committed to promoting and distributing insurance products. This commitment has to come from both senior management in terms of strategic inputs and the operations staff who would provide the frontend for these products. Prima facie, a formal collaboration between banks. There are costs associated with setting up a successful bancassurance network. The proper training of bank personnel to understand and market insurance schemes is vital to the success of these ventures. There is also a need to invest extensively in IT and other support systems that would provide an integrated 'back-end' for banking and insurance services Regulatory issues need to be addressed comprehensively and sorted out particularly with respect to competition and market structure problems. Given these changes, bancassurance and collaboration between banks and insurers has a long way to go in India. While bancassurance does provide an apparently viable model for product

NOTES

diversification by banks and a cost-effective distribution channel for insurers, there are some potential areas of conflict between the two that need to be ironed out.

While the benefits of bancassurance appear somewhat clear, prima facie to all participants, the potential areas of conflict should not be glossed over. Recent surveys of Indian savers show that they perceive insurance as a 'savings' product rather than as a risk management product There lies the rub. If insurance is indeed viewed as a savings instrument, the insurer's products compete directly with term deposits facilities that banks offer and there could be conflict of interest. Thus branchbankers might not have any incentive, indeed have a negative incentive, in promoting insurance products. Even if there is no direct competition between the banks and the insurance product portfolios, bankers under the current structure might not find it in his interest to hard-sell insurance. Lack of familiarity with insurance products could be another deterrent.

Another potential source of conflict arises in a configuration where the insurance company is promised by an international bank that might have an-insurance business interest in India. In such an instance the domestic partner bank of the insurance company might find it strategically necessary to hold bank sensitive customer information.

2.2. BANK ASSURANCE – CHALLENGES AND OPPORTUNITIES IN INDIA

Reasons for growing phenomena of Bank assurance:

The opening up of the insurance industry to private sector participation in December 1999 has led to the entry of 20 new players, with 12 in the life insurance sector and eight in the non-life insurance sector. Almost without exception these companies are seeking to utilize multiple distribution channels such as traditional agency, Bank Assurance, brokers and direct marketing. Bank assurance is seen by many to be a significant or even the primary channel (the latter being the case for at least SBI Life).

In other Asian markets we have seen bank assurance make significant headway in recent times. For example, bank assurance accounted for 24% of new life insurance sales by 'weighted' premium income in Singapore in 2002. This is a significant increase on the equivalent 2001 statistic of 15% and is as a result of growth in significant bank-centric

NOTES

bank assurance operations. In Hong Kong the figure for 2002 is expected to be at the 20% level for the same basic reasons.

- Life insurance premium represents 55% of the world insurance premium, and as the life insurance is basically a saving market. So it is one of the methods to increase deposits of banks.
- In non-life insurance business banks are looking to provide additional flow of revenues from the same customers through the same channel of distribution and with the same people.
- Insurers have been turning in ever-greater numbers to alternative modes of distribution because of the high costs they have paid for agent services. These costs became too much of a burden for many insurers compared to the returns they generated.
- Insurers operate through banc assurance own and control relationships with customers. Insurers found that direct relationships with customers gave them greater control of their business at a lower cost. Insurers who operate through the agency relationship are hardly having any control on their relationship with their clients.
- The ratio of expenses to premiums, an important efficiency factor, it is noticed very well that expenses ratio in insurance activities through banc assurance is extremely low. This is because the bank and the insurance company is benefiting from the same distribution channels and people.
- It is believed that the prospects for increased consolidation between banking and insurance is more likely dominated and derived by the marketing innovations that are likely to follow from financial service modernization. Such innovations would include cross selling of banking, insurance, and brokerage products and services; the increased use of the Internet by consumers; and a melding of insurance and banking corporate cultures.
- One of the most important reason of considering Banc assurance by Banks is increased return on assets (ROA). One of the best ways to increase ROA, assuming a constant asset base, is through fee income. Banks that build fee

income can cover more of their operating expenses, and one way to build fee income is through the sale of insurance products. Banks that effectively cross-sell financial products can leverage their distribution and processing capabilities for profitable operating expense ratios.

- By leveraging their strengths and finding ways to overcome their weaknesses, banks could change the face of insurance distribution. Sale of personal line insurance products through banks meets an important set of consumer needs. Most large retail banks engender a great deal of trust in broad segments of consumers, which they can leverage in selling them personal line insurance products. In addition, a banks branch network allows the face-to-face contact that is so important in the sale of personal insurance.
- Another advantage banks have over traditional insurance distributors is the lower cost per sales lead made possible by their sizable, loyal customer base. Banks also enjoy significant brand awareness within their geographic regions, again providing for a lower per-lead cost when advertising through print, radio and/or television. Banks that make the most of these advantages are able to penetrate their customer base and markets for above-average market share.
- Other bank strengths are their marketing and processing capabilities. Banks have extensive experience in marketing to both existing customers (for retention and cross selling) and non-customers (for acquisition and awareness). They also have access to multiple communications channels, such as statement inserts, direct mail, ATMs, telemarketing, etc. Banks' proficiency in using technology has resulted in improvements in transaction processing and customer service.
- By successfully mining their customer databases, leveraging their reputation and distribution systems. (branch, phone, and mail) to make appointments, and utilizing 'sales techniques. and products tailored to the middle market, European banks have more than doubled the conversion rates of insurance leads into sales and have increased sales productivity to a ratio which is more than enough to make banc assurance a highly profitable proposition.

- Insurers have much to gain from marketing through banks. Personal-lines carriers have found it difficult to grow using traditional agency systems because price competition has driven down margins and increased the compensation demands of successful agents. Over the last decade, life agents have sold fewer and larger policies to a more upscale client base. Middle-income consumers, who comprise the bulk of bank customers, get little attention from most life agents. By capitalizing on bank relationships, insurers will recapture much of this under served market.
- Most insurers that have tried to penetrate middle-income markets through alternative channels such as direct mail have not done well. Clearly, a change in approach is necessary. As with any initiative, success requires a clear understanding of what must be done, how it will be done and by whom. The place to begin is to segment the strengths that the bank and insurer bring to the business opportunity.

OPPORTUNITIES OF INSURANCE TO ENTER INTO BANC ASSURANCE

Insurance companies have identified a number of advantages from involvement in banc assurance:

– *source of new business*, from these possible reasons:

- the bank's clients are in a territory where the insurer has only a limited presence (if any), e.g. because the insurer's agency structure there is limited;
- the *bank's clients may form a very different group* (e.g. by age, sex, purchasing habits) to the one which the insurer has previously courted. For example, an insurer who previously concentrated on high net worth individuals ("HNWIs") can now gain access to a wider range of customers who will not all be HNWIs;

– *wider range of products* (including banking products): the insurance company hopes to attract further business, from both existing and new policyholders, because of the fact that it can offer a wider range of services than before, i.e. it can give its customers access to banking as well as to insurance services;

– *products not otherwise feasible*: the economics of the banc assurance operation may allow the insurer to offer products which are not feasible through the insurer's

existing channels. For example, sales costs incurred under existing channels may force premium rates for a product to be uncompetitive, so the product is not sold. The costs via the banc assurance channel may be low enough to make it feasible;

– *administration* – economies of scale: the insurance company can offer to carry out the administration activities of the bancassurer's business, if for example the bancassurer is a separate company. Combining the bancassurer's business with the other business of the insurer can produce economies of scale in administration costs (including capital expenditure). This in turn allows the insurer to improve profitability and to price future products with narrower margins, which helps to make the insurer's products more competitive.

BANCASSURANCE IN INDIA SWOT ANALYSIS

Although banks and insurance companies are yet to exchange their wedding rings bancassurance is already in some form in India. Banks are selling personal accident and baggage insurance for its credit card members, issued mortgage linked insurance products like fire, motor or cattle insurance to their customers and establishing face to face relationship with their customers by leveraging their existing capabilities. In order to implement the bancassurance model in India a lot of steps should be taken. a) High capital investment in the infrastructural development particularly in IT and Tele Communications will have to be required. b) A call centre will have to be created. c) Top professionals will have to be hired. d) R& D cell will have to be created to generate new ideas and products. Before going into the detailed progress of bancassurance around the world a SWOT analysis is done in the context of India.

STRENGTHS :-

In a country like India of one billion people where sky is the limit there is a vast untapped potentials waiting for life insurance products. There are more than 900 million lives waiting for life cover, 200 million house hold waiting for household insurance policy. Millions of people travelling in and out of India are waiting for overseas mediclaim and Travel insurance policies whole world is eyeing on the second largest middle class segment after China to tap. Other than this there is a huge pull of skilled professionals to relocate the bancassurance venture to provide new product through R&D

last of all, LIC & GIC have large branch net work facility to implement bancassurance model very effectively.

WEAKNESSES :-

In the case of rapid growth of Information Technology banks and insurance companies are still lacking its implementation. Though it is awakening but it is too late and too little. In the age of Wide Area Network (WAN) and Vast Area Network (VAN), simple LAN has not yet been introduced even in the head-quarters. As discussed earlier about the untapped middle class segments, they are over burdened with the inflationary pressure and tax exemption for all insurance products will inspire the customers (though it is done partially) to be insured. Another one is inflexibility of the products, i.e. they are not tailor-made to the requirements of the customer.

OPPORTUNITIES :-

Though not at the same level, banks data base in India is enormous and has to be dissected variously and various homogeneous groups are chummed out in order to position bancassurance products. With a good IT structure they can really do wonders. Appropriate atmosphere and political conscientious have to be built up for liberalisation and if it is done then RBI or IRA should have no hesitation in allowing the marriage of banking and insurance sectors to take place. Merger and Acquisition or setting up of joint venture is necessary in this direction.

THREATS :-

Success of bancassurance venture requires change in approach, thinking and work culture on the part of everybody involved. In India there is always a tendency to restrict any change whether its impact becomes favorable or not. So there should be a clear vehemence. Sometimes nonresponse from the target customers becomes possible threat as it was found in USA in 1980's and failed. US banks have turned their attention (since late 1990's) towards life insurance. Again the investors in the capital may turn their face in case the rate of return on capital falls short of the existing return on capital. So the return from bancassurance must at least match those returns. Also unholy alliances are

NOTES

not allowed to take place as there will be fierce competition in the market resulting in lower price.

The banking and insurance in dustry have changed rapidly in the changing and challenging economic environment through out the world. In the competitive and liberalised environment everyone is trying to do better than others and consequently survival of the fittest has come into effect. Insurance companies are also to be competitive by cutting cost and serving in a better way to the customers. Now the time has come to choose and adopt appropriate distribution channel through which the insurance companies can get the maximum benefit and serve. customers in manifolded ways. The intermediaries in the insurance business and the distribution channels used by carriers will perhaps be the strongest drivers of growth in this sector. Multi channel distribution and marketing of insurance products will be the smart strategy of continue to play an important role in distribution, alternative channels like corporate agents brokers and bancassurance will play a greater role in distribution. The time has come for the industry to gradually move from traditional individual agents towards new distribution channels with a paradigm shift in creating awareness and not just selling products. The game is old but the rules are new and still developing. Ensconed in a monopoly run from the nationalized days beginning in 1956, the insurance industry has indeed awakened to a deregulated environment in which several private players have partnered with multinational insurance giants. However despite of its teaming one billion population, India still has a low insurance penetration of 1.95 percent, 51st in the world. Despite the fact that India boosts a saving rate around 25 percent, less than 5% is spent on insurance. To streamline the saving into insurance, bancassurance is the best channel to tackle four challenges facing the industry :- product innovation, distribution, customer service and investments.

CHECK YOUR PROGRES

2. What are the threats faced by bank assurance promoters in India?

WHY BANK ASSURANCE IN INDIA?

The management of the new Indian operations is conscious of the need to grow quickly to reduce painful start-up expense overruns.

Banks with their huge networks and large customer bases give insurers an opportunity to do this efficiently. Regulations requiring certain proportions of sales to the rural and social sectors give an added impetus to the drive for 'bancassurance'. Selling through traditional methods to these sectors can be inefficient and expensive. Tying up with a bank with an appropriate customer base can give an insurer relatively cheap access to such sectors. This is still an issue for insurers despite the recent widening of the definition of the rural sector (so that it now accords with the census definition).

In India, as elsewhere, banks are seeing margins decline sharply in their core lending business. Consequently, banks are looking at other avenues, including the sale of insurance products, to augment their income. The sale of insurance products can earn banks very significant commissions (particularly for regular premium products). In addition, one of the major strategic gains from implementing bank assurance successfully is the development of a sales culture within the bank. This can be used by the bank to promote traditional banking products and other financial services as well. 'Bancassurance' is not simply about selling insurance but about changing the mindset of a bank. In addition to acting as distributors, several banks have recognised the potential of insurance in India and have taken equity stakes in insurance companies. This is perhaps the precursor of a trend we have seen in the United Kingdom and elsewhere where banks started off as distributors of insurance but then moved to a manufacturing role with fully owned insurance subsidiaries.

CONCLUSION :-

It is learnt from the above discussion that bancassurance in many countries has developed its form gradually where banks at first do not carry risks and distribute insurance products for a fee and product development is left to insurance company. But gradually banks have assumed risks regarding distribution assuming full responsibility. But the proper implementation of bancassurance is still facing some problems such as, poor manpower management, lack of sales culture with in the banks, detachment of branch manager, insufficient product promotion, managerial database expertise, inadequate incentives, negative attitude towards insurance etc.

In order to get the full benefit of it the following steps should be taken:-

i) Service delivery mechanism should be strengthened.

ii) Knowledge of target customer needs should be developed.

iii) Extensive and high quality training should be ensured.

iv) Strategies consistent with the banks vision should be developed.

v) Bank's data base system should be made flexible to cope with the change.

So observing the progress of different countries including India (particularly with reference to SBI) bancassurance is gaining world-wide acceptance gradually. The time has come to position your company for the new millennium of insurance product distribution through the strategic partnership of banks and insurance companies. Banks, insurance companies and traditional fund management houses are converging towards a model of global retail financial institution offering a wide array of products creating a one stop-shop where mortgages, savings, pensions and insurance products will be available.

TRAINING – A CRITICAL COMPONENT FOR BANK ASSURANCE IN INDIA

A.Structuring the organisation and building effective HR policies for successful bancassurance in India

Despite the rapid growth of bancassurance in India and the growing interest shown by Indian banks (especially the state-owned banks) to become equity partners in insurance joint ventures with foreign insurers, many Indian banks are yet to properly understand the various dimensions of the insurance business. Banks have particularly shown low awareness regarding the human resource (HR) aspects to make a success of the insurance selling activity. Large state-owned banks in India have HR policies and practices similar to those prevailing in government organisations, and have been slow to appreciate the pragmatic and market driven HR policies and practices required to compete with the new generation insurance companies.

This article looks at the HR challenges in insurance operations involving banks, and how banks would stand to gain more by changing their attitudes and refining their policies, whether as equity partner in an insurance JV or as a third party distributor of insurance products.

Value creation through bank partnership

The importance of the banking sector for new insurance companies in India is obvious. Banks dominate the Indian financial scene, with about 48 per cent of household savings held in the form of bank deposits, and banks meeting over 60 per cent of the credit needs of the corporate sector. Commercial banks are the first choice for multinational insurance companies seeking equity partners to enter the Indian insurance market. Banks are also the prime targets for existing players seeking to broaden their distribution capability outside the standard agency channel.

The key consideration for an insurer in a bancassurance model is how a partnership with a bank can effectively build value for the business through leveraging the bank's customer base, branch network, and its skilled manpower resources.

Unlike in an agency model, an organisation structure in a bancassurance JV company is usually less complex, involving fewer tiers of supervision and management. In the sales and marketing function in typical bancassurance companies, there are managers to effectively liaise with the bank partner and provide hand holding support to the bank branches, expecting the sales process to be handled by the bank staff who are trained for the purpose. This helps to keep the overall cost ratio low and enhances the capital efficiency in such operations.

For banks which are equity partners in the insurance business, the objective should ideally be to assist in building value in the JV by ramping up the sales volume through the bank sales staff who cater to various customer segments. A major consideration should be how to best allocate the bank's manpower resources for furthering the insurance business which is established in the name of the JV. Depending on the key objectives in the banking business such as customer acquisition, customer retention, or securing a better share of the customer's wallet, the senior bank managers should choose to utilise the frontline staff resources most likely to optimise the results.

At the strategic level, the bank's vision in a bancassurance operation should be to see how effectively the insurance business generates value and thereby favourably

impacts the bank's balance sheet. By closely monitoring the insurance joint venture, the bank should keep a tab on the efficiency of capital employed in the insurance business and the growth rate in employee productivity levels through the cross selling role.

Where a bank is just a third party distributor of insurance products without any equity investment commitment in the insurance manufacturing, the bank should be solely concerned to raise the productivity from insurance sales and the growth rate of the bank's fee based income from insurance.

A bank's ability to effectively tap its human resource potential is therefore of paramount importance.

B. Scope for fresh approaches

In bancassurance ventures with equity participation by banks, it is important that banks clearly understand their long term role in the insurance business and actively participate in the planning process, especially on the HR front. There are three major aspects to be borne in mind in this respect in the Indian context.

First, pay close attention to the organisation design and staffing aspects in a bancassurance business model.

As earlier stated, compared to insurance companies that are solely agency driven, bancassurance companies tend to have a leaner structure. It may be important to create positions in the insurance company that have linkages with those key business segments in the parent banks which are most likely to contribute to the insurance operations and development. For example, most major banks in India have multiple customer segments spanning retail customers, corporate, medium and small sized business firms, overseas clients including non-resident Indian account holders etc. The JV should aim to establish linkages with each of these segments through positions and reporting relationships that help to leverage the in-house insurance business potential.

An important issue in bancassurance JVs during the early stages is recruitment to key positions, and the role that can be assigned to managers who could be sent on secondment from the bank partner to the insurance company. While recruitment of talented managers from the open market is important, it is also crucial to get a modest contingent of highly capable managers from the bank partner to assume key responsibilities in the sales, marketing and other key functions in the JV. Indian experience shows that where a bank partner sends on secondment to the JV a set of chosen executives possessing well rounded experience and strong marketing orientation, it enhances the overall business capabilities of the insurance JV.

In addition to marketing and product design roles, capable bank managers are seen to play a crucial role in managing the policy administration function relating to the bancassurance business originating from the bank branches. They are usually in a position to establish better rapport with their counterparts at the parent bank and can thus help to smooth the sales and customer service activity levels.

Bancassurance business is generally more operations-intensive as bank branches in India tend to generate large volumes of low size cases. As the insurance business covers more remote branches in the banking network, this becomes more pronounced, often giving rise to considerable operational issues relating to premium collection and follow up of default cases. The organisational design in a bancassurance JV should take into account these realities, and develop a scalable structure that can effectively service large, small and micro insurance businesses originating from the bank branches. We have come across highly centralised organisational structures in insurance companies which often fail to meet the expectations of the branch network of the banking partner in crucial operational areas.

The organisation design should also carefully factor the opportunity to outsource certain activities in the bancassurance business. Successful bancassurance operations are built around a model where operational support to bank branches is substantially out-sourced. We have seen growth in the number of agencies in India which specialise in the provision of such outsourced services. The key task at the insurance JV should be to

identify such capable agencies and effectively monitor their performance, rather than creating large internal structures to support the function in-house.

Secondly, while generally aligning the HR policies and practices in bancassurance ventures to market conditions, it is important to craft them to reflect the value systems of the bank equity partners.

While aggressively competing with other players, bancassurers may tend to follow agency-driven competitors in respect of HR policies and practices. This may lead to some lack of sensitivity to the core practices of the bank partners, and thereby has the potential to sour the relationship among the sponsoring JV partners over a period.

Bancassurance ventures need to set recruitment policies that are highly transparent and reflective of the value systems of the bank partner while not compromising on the quality of candidates.

In respect of compensation practices, it is equally important to recognise the need for transparency and moderation. In our experience, most potential candidates are attracted to a bancassurance venture due to its association with a bank and the value systems for which the bank is known. Some of the aggressive compensation practices known in agency driven companies, such as a disproportionate element of variable pay in relation to fixed component, or a high element of performance related pay for bancassurance platform sales might be out of place in a bancassurance JV which should build value through moderate, long term approaches.

Banks generally have in place a fair regime of administering human resource policies with high transparency and trust. For example, in the area of performance appraisal, banks tend to follow a balanced approach and provide ample opportunities for staff to improve their performance, often through a mentoring approach with the help of senior personnel. Insurance JVs with major stakes from bank partners need to reflect such practices which could considerably enhance long term value and lead to stable growth.

Thirdly, the HR team should aim to nurture the blend of talent drawn from various resource pools into the insurance venture into a distinct and cohesive unit.

In Indian insurance ventures the human resource pool is drawn from three different sources: a set of staff recruited or appointed by the overseas partner, managers seconded by the bank partner, and a large complement of staff recruited from the market with diverse backgrounds.

The human resource policies in insurance ventures need to balance the aspirations and concerns of this diverse pool, and help them to integrate into a common mould. This is likely to be one of the most significant challenges in a bancassurance venture, and it is important to have the right set of policies in place to support this objective from an early stage of development of business.

HR issues for banks as third party distributors

In the matter of insurance distribution, the core HR challenge in banks stems from the need to move away from a transaction centric approach common in the banking environment to a sales and marketing approach relevant for selling insurance products. Since almost all banks have taken up third party distribution of insurance products, proper HR policies governing employees engaged in the distribution function can make a large impact in the Indian bancassurance scene.

In a recent *Bancassurance Benchmarking Survey* conducted by Watson Wyatt in India amongst banks and insurance companies, insurers overwhelmingly responded and referred to *"lack of support from the bank staff"* and *"difficulty in making insurance sales part of the KPI of the branch staff"* as the main issues hampering the growth of insurance distribution at bank branches (Figure 6).

Bank Assurance India-An Emerging Concept

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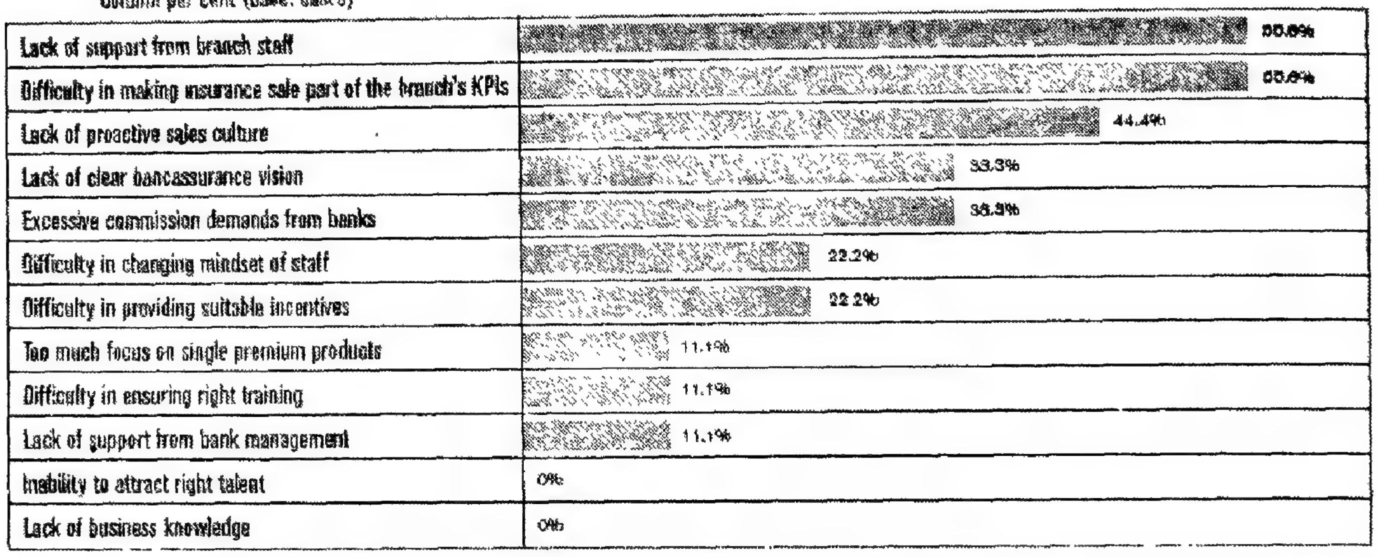
Figure 6 | Rank the following issues faced by your insurance company currently in the development of your bancassurance business – column per cent (base: cases)



Source: Watson Wyatt *Bancassurance Benchmarking Study India 2007*

The lack of enabling HR policies and practices in banks has often been referred to by the respondents as the main responsible factor.

Banks that have achieved significant growth in fee-based bancassurance income in Europe and Asia Pacific have demonstrated the importance of putting in place three key initiatives in distribution.

First, successful banks create competitive conditions internally to draw the best from their employees.

HR policies in banks that are successful in insurance distribution tend to be oriented in a manner that allows employees at every level to rise to their peak level of efficiency. In insurance distribution, banks in Europe are known to set specific goals for every frontline employee to cross sell insurance products. The employees take the initiative of identifying the best insurance product for their customers and complete the sales process.

Several banks, such as HSBC in Hong Kong, are successful in engaging their bank staff in insurance selling, setting key performance benchmarks for the activity. Every employee knows what is expected of them in terms of generating fee-based income, and the performance appraisal reflects the contribution in this aspect.. Such banks have ensured that the HR policies are geared to bring out the best marketing instincts from every frontline member of staff.

Secondly, banks that are successful in distributing insurance products provide performance-based incentives.

This may be a key issue of debate in Indian banks, especially in large state-owned ones, where rigid compensation policies are the norm. The situation may have changed slightly in the recent past with many public banks recognising better performing employees for promotion. However, a proper incentive scheme to recognise cross selling initiatives is yet to gain wide currency in banks.

Despite a tight remuneration framework, it is possible to design incentive schemes for bank staff to recognise best group and individual performances, and institute a reward system consisting of both monetary and non-monetary forms of recognition.

However, insurance JVs as well as insurance companies engaging banks for third party distribution need to tread the path of employee incentives carefully. Bank management is known to welcome provision of incentives to staff, but are wary of its effect on the core banking business. It is also the case that a few insurers, in their attempt to achieve quick wins by offering attractive monetary rewards to bank sales staff, have met with backlash from employee unions which are known for their egalitarianism.

Insurance companies should work closely with their bank partners to understand the HR issues in banks, and help introduce an incentive system that is fair and sustainable over a long period.

Thirdly, banks successful in insurance distribution have paid considerable attention to employee training.

Successful banks engaged in insurance distribution in developed bancassurance markets spend considerable amounts of time and money on providing skills-based training to their staff. Regular training exercises to groups of bank employees and individual mentoring exercises by trained bank trainers create favourable results in bancassurance productivity and service levels in several markets.

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This may be an area where the HR managers in Indian banks need to understand international practices and be willing to make larger investments. Most banks in India have good in-house training facilities with large and well laid out campuses. With a better understanding of the training needs related to insurance selling and with support from their insurance partners, banks can better utilise their training resources to deliver high quality training in this area.

Our experience shows that successful banks engaged in the insurance sector in other countries have set up Bancassurance Training Academies to serve the training needs of their own staff and the sales personnel of their JVs connected with bancassurance sales. Such specialised training academies can become visible symbols of commitment to impart quality training in the cross selling function. There are even examples of Indian bank-owned training facilities which offer high quality training to other banks in India and even those from other emerging economies.

In summary, successful bancassurance is the outcome of banks and insurers working closely together either as insurance manufacturing partners or distributing insurance products. A sound organization structure in an insurance JV that is conducive to the growth of the bancassurance model helps to accelerate this integration. Proper HR policies and practices in banks engaged in insurance distribution will help them reap higher fee-based income through better productivity levels on the part of their staff.

Other reasons are:

Bank	Insurance Company
■ Customer retention	■ Revenue and channel diversification
■ Satisfaction of more financial needs under the same roof	■ Quality customer access
■ Revenue diversification	■ Quicker geographical reach
■ More profitable resource utilisation	■ Creation of brand equity
■ Enriched work environment	■ Leverage service synergies with Bank
■ Establish sales orientated culture	■ Establish a low cost acquisition channel

In 2007, India has 88 scheduled commercial banks (SCBs) - 28 public sector banks (that is with the government of India holding a stake), 29 private banks (these do not have government stake; they may be publicly listed and traded on stock exchanges) and 31 foreign banks. Altogether they (banks) have a combined network of over 53,000 branches and reach in urban, semi urban & rural areas of nation. There are 70324 bank offices are there in India and around 16000 people are served by each bank office. It's a huge banking infrastructure and among best banking network in world.

ANSWERS TO CHECK YOUR PROGRESS

1. Growing Indian economy, inflow of FDI, expansion of middle income class and huge banking infrastructure in India.
2. Success of banc assurance venture requires change in approach, thinking and work culture on the part of everybody involved. In India there is always a tendency to restrict any change whether its impact becomes favorable or not. So there should be a clear vehemence.

REVIEW QUESTIONS:

1. Why is the prospect of bank assurance bright in India?
2. What are the threats faced by bank assurance promoters in India?

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UNIT 3

MAKING BANK ASSURANCE REALLY WORK

CHECK YOUR PROGRESS

1. What is the basis for development of customer-centric business process model?

3.1. INTRODUCTION

Banks and other financial services providers continuously claim to offer customer-oriented services, yet they still focus on delivering products instead of providing solutions to their customers' needs. For instance, banks offer business customers only products and services that solve isolated problems, such as liquidity, financing, and investment services, and fail to reflect the intrinsic requirements of business clients, such as procurement, order fulfillment, and sales. Hence, customers are rarely fully satisfied with banking services. Consequently, the consistent alignment of financial services to customer processes becomes increasingly important for enhancing the competitiveness of banks.

This paper will present the design of a customer-centric business process model, which allows banks to closely align their business processes with those of their customers and as a result achieve a high level of customization and to provide a new spectrum of services that add value to the clients. The sample that will be analyzed in this paper will comprise of small and medium sized enterprises.

3.2. DESIGN OF A CUSTOMER-CENTRIC BUSINESS PROCESS MODEL

The basis for the development of a customer-centric business process model is the identification of sub-processes for a specific customer process. Then each sub-process has to be analyzed to determine whether products and services could be conceivably provided in order to support them. In the next step, the bank has to analyze whether the specific customer sub-process could be supported by the bank itself or by a cooperation partner. Finally, detailed product and service packages, as well as sales and communication channels, have to be defined. This definition has to refer to both the in-house products and services and those of the cooperating partners. Thus, the bank's business process will be fully based on the business needs of its SME clients.

3.3. STEPS OF THE ACQUISITION AND SALES PROCESS

As a starting point within this process, an SME uses market analyses to examine the current and future market situation and the surrounding environment in which the enterprise is acting (sub-process — analyze target market). On the basis of the attained information potential customers are identified and acquired (acquire customers). Then, strategies, such as product strategy and product line policy, are formulated. In the next sub-process (analyze customer requirements), individual products have to be developed according to the customer's specifications. In addition, the production costs have to be calculated. The SME also has to provide advice (give product advice) and make an offer to the customer (provide offer). In a next process step, the contract has to be negotiated. At the order's due date, the products for the customer have to be prepared for shipment and dispatched (order processing). Simultaneously, an invoice is issued and the invoice amount posted to the accounts receivable ledger. If the customer does not pay on time, the commercial and, if necessary, legal dunning proceeding starts. After having identified the sub-processes of the SMEs' acquisition and sales process, each has to be matched against possible products and services that the bank might be able to offer. Within the target market analysis comprehensive market data could be offered to the enterprise, such as detailed information on potential customers and the targeted market, as well as market prospects and competition analyses. Generally, publications, road shows, advertisements,

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and sales promotions (i.e., calculation of discounts, design of payment options, provision of turnover credits, and other additional services) could be helpful in acquiring customers. Information about competitors, such as prices, delivery time, and quality measures, can help the SME to prepare a competitive offer. Additionally, the SME could develop financing packages or terms, such as loans and subsidies, for winning the business. The buyer's credit rating could be used to evaluate the solvency of the contract partner. If the sales negotiations result in a complex contract (i.e., in the case of selling a plant and/or delivering to certain countries) legal consultancy will be necessary. Furthermore, fulfilling guarantees or document transactions in the export business, such as letters of credit, can be covenanted as contract assurance. For transportation of goods, logistic companies like shipping contractors or specialized mail-order firms have to be involved, making transport insurance desirable. Finally, support during the suspension of payments or insolvency of the SMEs' clients might be necessary as well. Analogous to the acquisition and sales process of the selling company, the diverse sub-processes could also be identified for the resourcing process of the buying company. The identified sub-processes have to be checked for suitable products and services in the same way as shown above.

CHECK YOUR PROGRESS

2. Name the factors that play a vital role in the success of bank assurance?

3.4. STRUCTURE OF THE BUSINESS PROCESS MODEL

As demonstrated above, the acquisition and sales process, as well as the resourcing process, can be substantially supported by value-added products and services offered by banks. Yet, a bank should not necessarily produce and deliver all aforementioned ancillary services on its own. In fact, such a product or service extension might result in the dilution of the core competencies of a bank, such as provision of financing, and additional products and services could probably not be offered at competitive prices. However, products and services which support the customer processes can be offered by cooperation partners, such as insurance companies, leasing partners, mortgage banks, market research companies, consultancies, agencies for business news, patent offices, etc. Cooperations between a bank as a service integrator and partners as services providers appear to be a favorable approach. The customer processes provide the conceptual basis of this model. The bank as a service integrator holistically supports certain customer

processes and integrates the service components of shared services providers (i.e., banks specialized in back-office transactions),

The model allows banks to integrate themselves into the processes of their customers. There are many steps involved in implementing such a customer-centric process model. The required products and services of the respective sub-process, as well as the related prices, need to be analyzed explicitly within a requirements, acceptance, and pricing study.

3.5 ANSWERS TO CHECK YOUR PROGRESS

1. The basis for the development of a customer-centric business process model is the identification of sub-processes for a specific customer process.
2. Design of a customer-centric business process model Acquisition and sales process Structure of the business process model

3.6. REVIEW QUESTIONS:

1. What are the factors that play an important role in making bank assurance effective?
2. What is the basis for the development of a customer-centric business process model?

UNIT 4

NEW TRENDS IN WORLD BANK ASSURANCE

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4.1.INTRODUCTION

CHECK YOUR PROGRESS

1. When did bank assurance develop at its rapidest in Europe?

One of the most significant changes in the financial services sector over the past few years has been the appearance and development of banc assurance. Banking institutions and insurance companies have found banc assurance to be an attractive and profitable complement to their existing activities. Banc assurance covers a wide range of detailed arrangements between banks and insurance companies, but in all cases it includes the provision of insurance and banking products or services from the same sources or to the same customer base. Because there is a wide diversity of strategies, there is no standard model for banc assurance, even within a country. "Banc assurance is the provision of insurance and banking products and services through a common distribution channel and/or to the same client base." Thus, the concept of banc assurance differs considerable from one country to another, especially regarding the way in which the banks and the insurance companies use each other's distribution channels. The choice of banc assurance models depends on specific socio-economic, cultural and regulatory environment, the market infrastructure and consumer preferences.

4.2. EUROPE AND BANK ASSURANCE

Most developments on Europe in banc assurance was started to the mid-1990s, and banks and insurers in other parts of the world, e.g. the USA, Canada and Asia, are now developing banc assurance operations. In doing so, they seek to learn from the

experiences of European bancassurers. According to a study12, out of 8593 commercial banks of the United States, over 4150, meaning almost 50%, have been involved in the insurance sector, gaining important amounts from commission. Banks considered as big dimensions - the ones with assets of over 10 billion USD - have had the biggest involvement in the insurance sector, of over 80%, and gather 60% of the total received commission.

Europe has the highest banc assurance penetration rate, with life banc assurance accounting for more than half of premium income in many markets. The banc assurance system presently has a determinant part on the life-insurance markets of Spain, Portugal, Italy, Belgium and France (between 60-88% of market share). Developed through alliances formed between insurance companies and commercial banks, this modern channel of distribution didn't, however, have the expected success in countries like Great Britain, in which the life insurance market is structured around the brokerage companies, or like in Germany, where the role of traditional distribution channels is still predominant, around 75% of premiums being earned through this channel.

4.3. BANK ASSURANCE IN JAPAN

In Japan, CARDIF Group, established in 1973, is the insurance division of the BNP Paribas Group. It provides services specialising in bank assurance and offers cutting-edge insurance products to 50 million customers in over 40 countries.

The Japan branch office opened in May 2000, forming CARDIF Assurance Vie and CARDIF Assurances Risques Divers. Since that time the company has developed Japan's first creditor group life insurance product with a cancer insurance rider and has continued to focus on developing high value-added products that meet customer needs. CARDIF Group also provides Loan Repayment Insurance through over 70 sales partners, primarily regional banks. CARDIF Assurance vie launched medical insurance with maturity proceeds in July 2008. CARDIF Group continues to address the needs of financial institutions through its development and introduction of new products.

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PROSPECTS FOR BANCASSURANCE IN JAPAN

While banking operations are characterized by “due date control,” securities business and insurance sales activities are expressed as “control during the period (monitoring),” as stated previously. This is because a product has a long maturity, or has no maturity. With the sale of a product as the start, a long relationship with a customer begins. In the securities business, advice to a customer about daily price movements and trading fees that are generated based on such advice constitute a source of operating revenues. In the insurance business, in order to ensure that insurance premiums are regularly paid until maturity, sound sales operations and management are predicated on the management of customer information, advice about the payment of insurance premiums and related activities over a long time.

4.4. BANK ASSURANCE IN THE MIDDLE EAST REGION

Insurance products could be a major source of revenue for banks in the Middle East, but only if there are changes to legislation and internal culture, industry experts said yesterday. Bancassurance, the process by which banks sell insurance products to their customers, is still in the early stages of development in many Middle East countries, in some cases due to insufficient legislation. Currently the Mena region has one of the lowest insurance penetrations of less than 10 per cent. Global insurance statistics indicate that the insurance penetration and per capita premium density in the Middle East is comparatively low while the share of GCC countries is below the global average. According to estimates by Lloyds, the GCC's insurance penetration was 0.6 per cent of gross domestic product. According to recent estimates by Arab Insurance Group (AIG), the GCC region has the potential for a gross premium of more than $20 billion, but currently it is below $4.5 billion. While the life insurance penetration in the Middle East region is one of the lowest in the world, the property and casualty premiums (P&C) contribute the largest share to the total insurance premium in the region. "There is huge growth opportunity for insurance in the region. Years of misunderstanding and misconception have created mental blocks against insurance in the Muslim culture. Takaful is the way forward. However, distribution holds the key. With the bancassurance gaining ground, there is huge potential for growth in the region," said Oommen.

According to insurance industry players, bancassurance is becoming the norm rather than an exception in the region due to various factors such as the growing pressure on fund based revenue for banks, the popularity of universal banking and the drive towards optimum utilisation of resources are driving both banks and insurance players towards collaboration.

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Currently there are four models starting from a distribution agreement to strategic alliance, joint ventures and a full integration model where banks become one stop shop for financial services including insurance. According to a recent study by Booz Allen

CHECK YOUR PROGRESS

2. What are the reasons for banks to enter into bank assurance in UAE?

Hamilton, to increase insurance penetration the region should improve five key enablers of growth in the industry such as, legal frameworks, regulatory bodies and processes, nature of competition, skills and training, and market-led initiatives. With bancassurance offering huge synergies for both banks and insurance firms, experts said integration of distribution channels would create a win-win situation for both banks and insurance firms. The concept provides significant advantages not only to the banks and insurance companies but also to the customers. By utilising the bank's distribution network. insurance companies are able to reduce their distribution costs and pass on the benefit to their customers. Since its inception in France in the thirties,

Bancassurance has become immensely popular in most parts of the world. In the advanced countries in the West, it accounts for almost 25 per cent of all corporate insurance. However, it remains a virgin territory in the UAE and the Gulf region. The concept provides significant advantages not only to the banks and insurance companies but also to the customers. By utilising the bank's distribution network, insurance companies are able to reduce their distribution costs and pass on the benefit to their customers. Since its inception in France in the thirties, Bancassurance has become immensely popular in most parts of the world. In the advanced countries in the West, it accounts for almost 25 per cent of all corporate insurance. However, it remains a virgin territory in the UAE and the Gulf region.

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REASONS FOR BANKS TO ENTER INTO BANCASSURANCE IN UAE

The main reasons why banks have decided to enter the insurance industry area are the following:

Intense competition between banks, against a background of shrinking interest margins, has led to an increase in the administrative and marketing costs and limited the profit margins of the traditional banking products. New products could substantially enhance the profitability and increase productivity Financial benefits to a bank performance can flow in a number of ways, as briefly outlined below: -

Increased income generated, in the form of commissions and/or profits from the business (depending upon the relationship) – Reduction of the effect of the bank fixed costs , as they are now also spread over the life insurance relationship.

Opportunity to increase the productivity of staff, as they now have the chance to offer a wider range of services to clients.

Customer preferences regarding investments are changing. For medium-term and long-term investments there is a trend away from deposits and toward insurance products and mutual funds where the return is usually higher than the return on traditional deposit accounts. This shift in investment preferences has led to a reduction in the share of personal savings held as deposits, traditionally the core element of profitability for a bank which manages clients money. Banks have sought to offset some of the losses by entering life insurance business.Life insurance is also frequently supported by favourable tax treatment to encourage private provision for protection or retirement planning. This preferential treatment makes insurance products more attractive to customers and banks see an opportunity for profitable sales of such products.

MiddleEast Insurance Review, together with its sister publication, Asia Insurance Review which has hosted the popular Asian Bancassurance series of conferences annually for more than 10 years, is pleased to host the 3rd Middle East Bancassurance Conference in Dubai this year, to take stock of the latest developments and trends in the region and look at the theme: *"Banks and Insurers in Strategic Alliance to Boost Sale of Insurance*

As bancassurance brightens up in the Middle East, considered still at nascent stage, it represents huge potential and opportunities for banks and insurance companies in the

region. The bancassurance conference therefore is organised at an opportune time for banks and insurers to come together to learn from various business models and successful case studies, and find out how they can form strategic partnerships to be stronger and exploit the opportunities and dynamism of bancassurance and alternative distribution channels, to reap maximum benefits and profits.

4.5 ANSWERS TO CHECK YOUR PROGRESS

1. Most developments on Europe in banc assurance was started to the mid-1990s, and banks and insurers in other parts of the world, e.g. the USA, Canada and Asia, are now developing banc assurance operations.

2. Intense competition between banks; Increased income generated and; Opportunity to increase the productivity of staff

4.6. REVIEW QUESTIONS:

1. What are the reasons for banks to enter into bank assurance in UAE?
2. When did bank assurance develop at it's rapidest in Europe?

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UNIT 5

NATURE AND HISTORY OF INSURANCE BUSINESS

5.1. INTRODUCTION

The Insurance sector in India governed by Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and General Insurance Business (Nationalisation) Act, 1972, Insurance Regulatory and Development Authority (IRDA) Act, 1999 and other related Acts. With such a large population and the untapped market area of this population Insurance happens to be a very big opportunity in India. Today it stands as a business growing at the rate of 15-20 per cent annually. Together with banking services, it adds about 7 per cent to the country's GDP .In spite of all this growth the statistics of the penetration of the insurance in the country is very poor. Nearly 80% of Indian populations are without Life insurance cover and the Health insurance. This is an indicator that growth potential for the insurance sector is immense in India. It was due to this immense growth that the regulations were introduced in the insurance sector and in continuation "**Malhotra Committee**" was constituted by the government in 1993 to examine the various aspects of the industry. The key element of the reform process was Participation of overseas insurance companies with 26% capital. Creating a more

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efficient and competitive financial system suitable for the requirements of the economy was the main idea behind this reform.

Since then the insurance industry has gone through many sea changes .The competition LIC started facing from these companies were threatening to the existence of LIC .since the liberalization of the industry the insurance industry has never looked back and today stand as the one of the most competitive and exploring industry in India. The entry of the private players and the increased use of the new distribution are in the limelight today. The use of new distribution techniques and the IT tools has increased the scope of the industry in the longer run.

5.2. HISTORY OF INSURANCE SECTOR

The business of life insurance in India in its existing form started in India in the year 1818 with the establishment of the Oriental Life Insurance Company in Calcutta. Some of the important milestones in the life insurance business in India are given in the table 1.

Table 1: milestone's in the life insurance business in India

Year	Milestones in the life insurance business in India
1912	The Indian Life Assurance Companies Act enacted as the first statute to regulate the life insurance business
1928	The Indian Insurance Companies Act enacted to enable the government to collect statistical information about both life and non-life insurance businesses
1938	Earlier legislation consolidated and amended to by the Insurance Act with the objective of protecting the interests of the insuring public.
1956	245 Indian and foreign insurers and provident societies taken over by the central government and nationalised. LIC formed by an Act of Parliament, viz. LIC Act, 1956, with a capital contribution of Rs. 5 crore from the Government of India.

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The General insurance business in India, on the other hand, can trace its roots to the Triton Insurance Company Ltd., the first general insurance company established in the year 1850 in Calcutta by the British. Some of the important milestones in the general insurance business in India are given in the table 2.

Table 2: milestone's in the general insurance business in India

Year	Milestones in the general insurance business in India
1907	The Indian Mercantile Insurance Ltd. set up, the first company to transact all classes of general insurance business
1957	General Insurance Council, a wing of the Insurance Association of India, frames a code of conduct for ensuring fair conduct and sound business practices
1968	The Insurance Act amended to regulate investments and set minimum solvency margins and the Tariff Advisory Committee set up.
1972	The General Insurance Business (Nationalisation) Act, 1972 nationalised the general insurance business in India with effect from 1st January 1973. 107 insurers amalgamated and grouped into four companies viz. the National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd. and the United India Insurance Company Ltd. GIC incorporated as a company.

Indian Insurance Market – History

Insurance has a long history in India. Life Insurance in its current form was introduced in 1818 when Oriental Life Insurance Company began its operations in India. General Insurance was however a comparatively late entrant in 1850 when Triton Insurance company set up its base in Kolkata. History of Insurance in India can be broadly bifurcated into three eras: a) Pre Nationalisation b) Nationalisation and c) Post Nationalisation. Life Insurance was the first to be nationalized in 1956. Life Insurance Corporation of India was formed by consolidating the operations of various insurance companies. General Insurance followed suit and was nationalized in 1973. General Insurance Corporation of India was set up as the controlling body with New India, United India, National and Oriental as its subsidiaries. The process of opening up the insurance

sector was initiated against the background of Economic Reform process which commenced from 1991. For this purpose Malhotra Committee was formed during this year who submitted their report in 1994 and Insurance Regulatory Development Act (IRDA) was passed in 1999. Resultantly Indian Insurance was opened for private companies and Private Insurance Company effectively started operations from 2001.

Insurance Market- Present:

The insurance sector was opened up for private participation four years ago. For years now, the private players are active in the liberalized environment. The insurance market have witnessed dynamic changes which includes presence of a fairly large number of insurers both life and non-life segment. Most of the private insurance companies have formed joint venture partnering well recognized foreign players across the globe.

There are now 29 insurance companies operating in the Indian market – 14 private life insurers, nine private non-life insurers and six public sector companies. With many more joint ventures in the offing, the insurance industry in India today stands at a crossroads as competition intensifies and companies prepare survival strategies in a detariffed scenario.

There is pressure from both within the country and outside on the Government to increase the foreign direct investment (FDI) limit from the current 26% to 49%, which would help JV partners to bring in funds for expansion.

There are opportunities in the pensions sector where regulations are being framed. Less than 10 % of Indians above the age of 60 receive pensions. The IRDA has issued the first licence for a standalone health company in the country as many more players wait to enter. The health insurance sector has tremendous growth potential, and as it matures and new players enter, product innovation and enhancement will increase. The deepening of the health database over time will also allow players to develop and price products for larger segments of society.

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State Insurers Continue To Dominate There may be room for many more players in a large underinsured market like India with a population of over one billion. But the reality is that the intense competition in the last five years has made it difficult for new entrants to keep pace with the leaders and thereby failing to make any impact in the market.

Also as the private sector controls over 26.18% of the life insurance market and over 26.53% of the non-life market, the public sector companies still call the shots.

The country's largest life insurer, Life Insurance Corporation of India (LIC), had a share of 74.82% in new business premium income in November 2005.

Similarly, the four public-sector non-life insurers – New India Assurance, National Insurance, Oriental Insurance and United India Insurance – had a combined market share of 73.47% as of October 2005. ICICI Prudential Life Insurance Company continues to lead the private sector with a 7.26% market share in terms of fresh premium, whereas ICICI Lombard General Insurance Company is the leader among the private non-life players with a 8.11% market share. ICICI Lombard has focused on growing the market for general insurance products and increasing penetration within existing customers through product innovation and distribution.

Reaching Out To Customers No doubt, the customer profile in the insurance industry is changing with the introduction of large number of divergent intermediaries such as brokers, corporate agents, and bancassurance.

The industry now deals with customers who know what they want and when, and are more demanding in terms of better service and speedier responses. With the industry all set to move to a detariffed regime by 2007, there will be considerable improvement in customer service levels, product innovation and newer standards of underwriting.

Intense Competition In a de-tariffed environment, competition will manifest itself in prices, products, underwriting criteria, innovative sales methods and creditworthiness.

Insurance companies will vie with each other to capture market share through better pricing and client segmentation.

The battle has so far been fought in the big urban cities, but in the next few years, increased competition will drive insurers to rural and semi-urban markets.

Global Standards While the world is eyeing India for growth and expansion, Indian companies are becoming increasingly world class. Take the case of LIC, which has set its sight on becoming a major global player following a Rs280-crore investment from the Indian government. The company now operates in Mauritius, Fiji, the UK, Sri Lanka, Nepal and will soon start operations in Saudi Arabia. It also plans to venture into the African and Asia-Pacific regions in 2006.

The year 2005 was a testing phase for the general insurance industry with a series of catastrophes hitting the Indian sub-continent.

However, with robust reinsurance programmes in place, insurers have successfully managed to tide over the crisis without any adverse impact on their balance sheets.

With life insurance premiums being just 2.5% of GDP and general insurance premiums being 0.65% of GDP, the opportunities in the Indian market place is immense. The next five years will be challenging but those that can build scale and market share will survive and prosper.

5.3. PRESENT SCENARIO OF INSURANCE INDUSTRY

India with about 200 million middle class household shows a huge untapped potential for players in the insurance industry. Saturation of markets in many developed economies has made the Indian market even more attractive for global insurance majors. The insurance sector in India has come to a position of very high potential and competitiveness in the market. Indians, have always seen life insurance as a tax saving device, are now suddenly turning to the private sector that are providing them new products and variety for their choice.

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Consumers remain the most important centre of the insurance sector. After the entry of the foreign players the industry is seeing a lot of competition and thus improvement of the customer service in the industry. Computerisation of operations and updating of technology has become imperative in the current scenario. Foreign players are bringing in international best practices in service through use of latest technologies

CHECK YOUR PROGRESS

1. What are the distribution channels currently available in the insurance market?

The insurance agents still remain the main source through which insurance products are sold. The concept is very well established in the country like India but still the increasing use of other sources is imperative. At present the distribution channels that are available in the market are listed below.

- Direct selling
- Corporate agents
- Group selling
- Brokers and cooperative societies
- Bancassurance

Customers have tremendous choice from a large variety of products from pure term (risk) insurance to unit-linked investment products. Customers are offered unbundled products with a variety of benefits as riders from which they can choose. More customers are buying products and services based on their true needs and not just traditional money back policies, which is not considered very appropriate for long-term protection and savings. There is lots of saving and investment plans in the market. However, there are still some key new products yet to be introduced - e.g. health products. The rural consumer is now exhibiting an increasing propensity for insurance products. A research conducted exhibited that the rural consumers are willing to dole out anything between Rs 3,500 and Rs 2,900 as premium each year. In the insurance the awareness level for life insurance is the highest in rural India, but the consumers are also aware about motor, accidents and cattle insurance. In a study conducted by MART the results showed that nearly one third said that they had purchased some kind of insurance with the maximum penetration skewed in favor of life insurance. The study also pointed out the private companies have huge task to play in creating awareness and credibility among the rural populace. The perceived benefits of buying a life policy range from security of income

bulk return in future, daughter's marriage, children's education and good return on savings, in that order, the study adds.

5.4. ROLE OF INSURANCE INDUSTRY IN ECONOMIC DEVELOPMENT

Considerable attention has been devoted to evaluating the relationship between economic growth and financial market deepening. Most of what we have learned relates to banking systems and securities markets – with insurance receiving only a passing mention. Yet, while insurance, banking, and securities markets are closely related, insurance fulfills somewhat different economic functions than do other financial services, and in turn requires particular conditions to flourish and to make a full economic contribution. Fortunately, in the past few years, several interesting lines of research have begun to map the specific contributions of insurance to the economic growth process as well as to the well-being of the poor. The evidence suggests that insurance contributes materially to economic growth by improving the investment climate and promoting a more efficient mix of activities than would be undertaken in the absence of risk management instruments. This contribution is magnified by the complementary development of banking and other financial systems. al studies suggest that nonlife insurance contributes to growth in countries at many different levels of development. Life insurance makes a substantial contribution to growth mostly in wealthier countries, since life insurance is typically a smaller part of the total insurance market in low income countries. The relationship between per capita income levels and insurance penetration is also strong in the reverse direction – with rising income a strong driver of life insurance coverage. However, it is difficult to disentangle whether lower insurance consumption at lower income levels reflects reduced demand for life insurance products or constraints on the supply side associated with weak regulatory and supervisory environments and high costs of insurance provision. Of course, even if the data did not support a strong causal role for insurance as an engine of overall aggregate growth, there might be a strong case for insuring the poor on social welfare grounds that those at or below the poverty line are particularly vulnerable to catastrophic shocks to income and consumption. And indeed, it appears that the gap between the potential social value of insurance and the transactions costs of provision might be unusually wide for the poorest segment of society, which

explains the growing interest in micro insurance on the part of non governmental organizations and philanthropic foundations, some of whom are partnering with commercial providers.

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CHECK YOUR PROGRESS

2. What are the factors that play a pivotal role in deciding the level of contribution of insurance to economic development.

CONTRIBUTIONS OF INSURANCE TO GROWTH AND DEVELOPMENT

Insurance serves a number of valuable economic functions that are largely distinct from other types of financial intermediaries. In order to highlight specifically the unique attributes of insurance, it is worth focusing on those services that are not provided by other financial services providers, excluding for instance the contractual savings features of whole or universal life products. The indemnification and risk pooling properties of insurance facilitate commercial transactions and the provision of credit by mitigating losses as well as the measurement and management of non diversifiable risk more generally. Typically insurance contracts involve small periodic payments in return for protection against uncertain, but potentially severe losses. Among other things, this income smoothing effect helps to avoid excessive and costly bankruptcies and facilitates lending to businesses. Most fundamentally, the availability of insurance enables risk averse individuals and entrepreneurs to undertake higher risk, higher return activities than they would do in the absence of insurance, promoting higher productivity and growth.

MEASURED CONTRIBUTION OF INSURANCE TO GROWTH

Given the multiple potential benefits of a vibrant insurance sector,

how much of a contribution does insurance make in practice? While still sparse, the research points to several relatively robust inferences:

1, Insurance contributes positively to economic growth

The deepening of insurance markets makes a positive contribution to economic growth. While life insurance is causally linked to growth only in higher income economies, non-life insurance makes a positive contribution in both developing and higher income economies. Some research suggests that the positive contribution of life insurance to growth is primarily through the channel of financial intermediation and long term investments. However, it is important to note that these studies do not address the important contributions to individual and social welfare from risk management.

2. Strong complementarity between insurance and banking

Insurance and banking system deepening appear to play complementary roles in the growth process. Although insurance and banking separately each make positive contributions to growth, their individual contributions are greater when both are present. There is also some evidence that the development of insurance markets contributes to the health of securities markets. As suggested above, there are many reasons why this complementary relationship might hold, including the likelihood that the presence of property casualty insurance avoids inefficiently high levels of bankruptcy and helps to facilitate credit transactions for houses, consumer durables, and small- and medium-sized businesses that banks typically finance. Separate evidence that a growing presence of life insurance providers and pension funds is associated with more efficient banks suggests that they promote some capital market discipline on the investment side that is also complementary.

Drivers of insurance coverage

Of course, if growing insurance markets make a positive contribution to growth, then it is important to understand in turn the enabling factors that contribute to the development of robust insurance markets. Here, the evidence points to rising incomes, macroeconomic stability, and financial deepening as the key drivers of insurance market growth, against the backdrop of a conducive regulatory and supervisory environment.

1, Rising Incomes, Moderate Inflation, and Financial Deepening are Key Drivers.

Growth in insurance coverage is strongly associated with rising incomes, the development of an increasingly sophisticated banking sector, and low or moderate levels of inflation.6 The strong contribution of rising incomes to greater insurance coverage might be attributable to demand factors (rising demand for coverage as individuals become wealthier), supply factors (it becomes more cost-effective to provide insurance as the economy expands, providing both a stronger institutional environment and greater returns relative to transactions cost), or a combination. The overall institutional environment plays an important role, in terms of political stability and openness as well as government effectiveness, rule of law, and control of corruption. Religious factors also

play a role, with insurance consumption inversely correlated to the share of the population that is Islamic.

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2. Variation in Insurance Coverage.

Although the key drivers noted above are relatively robust in explaining insurance market coverage, nonetheless there is substantial variation in insurance coverage among economies that cannot be fully explained by these factors. This suggests some idiosyncratic factors may be at work. Observers have noted an S-curve relationship between per capita income and insurance penetration: insurance penetration is moderately positively correlated with per capita income within the group of low income countries and the same is true for the highest income countries. However, within the group of middle income countries, insurance penetration is strongly positively correlated with per capita income. This S-curve is somewhat misleading however, since it compares countries at different levels of per capita income, but does not predict how insurance penetration will rise as an individual country becomes wealthier over time.

5.5. GLOBALIZATION OF INSURANCE MARKETS

Although the evidence suggests that insurance market deepening should be a priority in the financial sector strategies of developing countries, awareness of the role of insurance lags behind that of banking and capital markets. For these reasons, it is important to raise the visibility of this sector and to clarify what unique regulatory provisions might be needed to enable insurance market development alongside other facets of financial deepening. For many countries, a good starting point would be to include analysis and recommendations specifically for insurance in financial sector assessments.

1, Institutional Foundations for Insurance Market Development

The development of robust insurance markets generally requires many of the same foundations as for banking and financial market deepening: reasonable macroeconomic and political stability, clear property rights, enforceability of contracts, and safeguards against corruption. However, these are necessary but not sufficient conditions. Insurance

market deepening also depends on the scale and growth of related markets, including sales of cars and other consumer durables, residential and commercial mortgage markets, business establishments, disposable income, and commercial and trade transactions, to name a few. Growth in these related markets is critical in order for the nascent insurance industry to reach scale in developing shared infrastructure, underwriting capacity, statistical databases for actuarial purposes, and the associated skills. A variety of public goods are critical for jump starting and sustaining the growth of domestic insurance markets. These include the collection and sharing of data on a consistent basis, common supervisory principles, for instance on reserves and solvency, and consumer education. Recognizing the critical role of such public goods, several of the multinational development banks, international associations of regulators and supervisors as well as private sector associations are already active in providing technical assistance on all of these dimensions. According to an in-depth survey of the factors that have slowed the expansion of insurance markets in Latin America, the region's insurance professionals view the lack of sufficient education about insurance as the greatest impediment to market development. They also cited lack of confidence in the effectiveness of the judicial system and law enforcement's failure to collect information about thefts and automobile accidents as key impediments to market development.

2. Insurance for Different Stages of Economic Development

Although there is broad agreement on the need for adequate regulatory and supervisory frameworks, there is some debate on the content of these frameworks, and in particular the extent to which developing countries can or should harmonize their standards to global best practice or seek some intermediate standards. Global best practices relying on disciplined transparency and corporate governance are still largely lacking in many developing countries. For some regions within Africa and Latin America, a strong case can be made for the development of regional standards that are common across groups of neighboring countries or Free Trade Agreement (FTA) partners. Regional harmonization offers many benefits, and it can be a step toward global standards. The International Association of Insurance Supervisors has articulated the Core Principles of Insurance Supervision, but the implementation of those Core

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Principles has barely begun. Given the evidence connecting insurance market takeoff to achievement of middle income status, a case can be made that low income economies below this threshold should concentrate limited resources on either specific insurance segments (such as natural disaster risk mitigation) or other sectors. In countries with limited capacity, it makes sense to undertake institutional development sequentially – for instance focusing initially on laws and regulations that are foundational for overall financial sector expansion rather than specific to insurance. In parallel, the growing field of micro-insurance is likely to yield products and business models that contribute to social welfare and small enterprises in low income economies, while establishing broad familiarity with formal insurance and setting the stage for future growth as income rises.

3. Trade and Investment Liberalization and Insurance Markets

Expanding cross-boarder trade and investment will remain key drivers of insurance market growth. Trade fuels insurance market growth both indirectly – through the growing volume of transactions requiring insurance – and directly – by driving privatization and liberalization of insurance markets and the migration of new products across borders. As global insurance companies press forward on cross-border market liberalization, they would be well-advised to advocate just as actively for building consumer confidence in the regulatory and supervisory infrastructure of emerging insurance markets. Global industry leaders may find their victories short lived if they win major concessions in new markets on insurance market liberalization through WTO and bilateral free trade agreement negotiations, without putting appropriate emphasis on the concurrent development of regulations and prudential supervision as well as industry self-regulation. The hard won market opening can backfire when the actions of a handful of poorly regulated domestic providers undermine consumer trust, leading to adverse reputation effects for all providers that may take years to overcome.

INSURANCE AND ECONOMIC DEVELOPMENT

For economic development, investments are necessary. Investments are made out of savings. A life insurance company is a major instrument for the mobilization of savings

of people, particularly from the middle and lower income groups. These savings are channeled into investments for economic growth.

An insurance company's strength lies in the fact that huge amounts come by way of premiums. Every premium represents a risk that is covered by that premium. In effect, therefore, these vast amounts represent pooling of risks. The funds are collected and held in trust for the benefit of the policyholders. The management of insurance companies is required to keep this aspect in mind and make all its decisions in ways that benefit the community. This applies also to its investments. This is why successful insurance companies would not be found investing in speculative ventures. Their investments benefit the society the society at large. The system of insurance provides numerous direct and indirect benefits to the individual and his family as well as to industry and commerce and to the community and the nation as a whole. Those who insure, both individuals and corporate, are directly benefited because they are protected from the consequences of the loss that may be caused by the accident or fortuitous event. Insurance, thus, in a sense protects the capital in industry and releases the capital for further expansion and development of business and industry. The very existence of risk that is, uncertainty concerning the future, is a severe handicap in economic activities. Insurance removes the fear, worry and anxiety associated with this future uncertainty and thus encourages free investment of capital in business enterprises and promotes efficient use of existing resources. Thus insurance encourages commercial and industrial development and there by contributes to a vigorous economy and increased national productivity. Present day organization of industry, commerce and trade depend entirely on insurance for their operation, banks and financial institutions lend money to industrial and commercial undertakings only on the basis of the collateral security of insurance. No bank or financial institution would advance loans on property unless it is insured against loss or damage by insurable perils. Insurers are closely associated with several agencies and institutions engaged in fire loss prevention, cargo loss prevention, industrial safety and road safety. Before acceptance of a risk, insurers arrange survey and inspection of the property to be insured, by qualified engineers and other experts. The object of these surveys is not only to assess the risk for rating purposes but also to suggest and recommend to the insured, various improvements in the risk, which will attract lower rates of premium and what is

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more important , reduce the loss potential. For example, burglary surveyors make recommendation in regard to security measures such as better locking system, appointment of Watchman, etc. Engineering surveys play a most useful part in accident prevention as valuable technical advice is provided in respect of plant and machinery. Insurance ranks with export trade, shipping and banking services as earner of foreign exchange to the country. It helps to earn foreign exchange and represent invisible exports. For economic development, investments are necessary. Investments are made out of savings. A life insurance company is a major instrument for the mobilization of savings of people, particularly from the middle and lower income groups. These savings are channeled into investments for economic growth. The insurance Act has strict provisions to ensure that insurance funds are invested in safe avenues, like Government bonds, companies with record of profits and so on. As on 31.3.2006, the total investments of the LIC exceeded Rs 5, 20,000 crores, of which nearly Rs 3, 00,000 crores were directly in Government (both State and Centre) related securities, nearly Rs 16,000 crores in the State Electricity Boards, nearly Rs 22,000 crores in housing loans, Rs 19,000 crores in the power generation (private) sector and Rs 10,000 crores in water supply and sewerage systems. Other investments included road transport, setting up of industrial estates and directly financing industry. Investments in the corporate sector (shares, debentures and term loans) exceeded Rs 30,000 crores. These directly affect the lives of the people and their economic well-being. The L.I.C. is not an exception. All good life insurance companies have huge funds, accumulated through the payments of small amounts of premia of individuals. These funds are invested in ways that contribute substantially for the economic development of the countries in which they do business. The private insurers in India are new and have accumulate funds equal to about 1/8th of the L.I.C's. But even their investments in various sectors and contributing directly and indirectly to the country's economic development, would be of similar proportions. A Life insurance company's funds are collected by way of premiums. Every premium represents a risk that is covered by that premium. In effect, therefore, these vast amounts represent pooling of risks. The funds are collected and held in trust for the benefit of the policyholders. The managements of life insurance companies are required to keep this aspect in mind and make all its decisions in ways that benefit the community. This applies also to its

investments. That is why successful insurance companies would not be found investing in speculative ventures. Their investments, as in the case of the L.I.C. benefit the society at large. Apart from investments, business and trade benefit through insurance. Without insurance, trade and commerce will find it difficult to face the impact of major perils like fire, earthquake, floods, etc. Financiers, like banks, would collapse if the factory, financed by it, is reduced to ashes by a terrible fire. Insurers cover also the loss to financiers, if their debtors default.

5.6 ANSWERS TO CHECK YOUR PROGRESS

1. Direct Selling; Corporate Agents; Group Selling; Brokers and Co-operative Societies and Bank assurance
2. Insurance Contributes Positively to Economic Growth; Strong Complementarity between Insurance and Banking.

5.7 REVIEW QUESTIONS

1. What are the distribution channels currently available in the insurance market?
2. What are the factors that play a pivotal role in deciding the level of contribution insurance makes to the economic growth of a country?

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> **CHECK YOUR PROGRESS**
> 1. Explain the Principle of Insurable Interest?

UNIT 6

PRINCIPLES AND LEGAL ASPECTS OF INSURANCE

6.1.INTRODUCTION

The owner of property has a right under law to effect insurance on the property if he is likely to suffer financially when the property is lost or damaged. This legal right to insure is called insurable interest. Without insurable interest, the contract of insurance will be void. Because of this legal requirement of insurable interest, insurance contracts are not gambling transactions.

6.2. PRINCIPLE OF INSURABLE INTEREST

Ownership of property (and joint ownership) is a clear example of insurable interest.

Providing credit facility is one of the most popular transaction services offered by a retailer. Retailers help customers purchase the goods without the need to carry cash. Apart from this, it provides a "buy now pay later" facility. Retailers can serve their customers better by offering excellent packaging. The packing service of a retailer should be well coordinated with the overall image of the store and type of merchandise it sell.

Merchandise availability is a type of transaction service that helps customers locates the merchandise they wish to buy. By having a well-designed layout along with various point of purchase displays and helpful sales personnel, retailers can make it relatively easier for customers to locate the merchandise.

Customers usually evaluate a sales transaction by the time taken to check out of the store after the merchandise has been selected, the friendly nature of employees at the billing counter, and honoring credit cards. The final transaction services offered by retailer should ensure that customers do not leave the store with any bad experience.

III) Post transaction services:

Post transaction services are those services that are provided by the retailer to the customers after the merchandise or the service has been purchased. Retaining a customer is the most complex task for a retailer because of the increasing competition. Hence, most of the large retailers are now developing customer loyalty programs.

Complaint handling, merchandise exchange handling, repairing, free service and delivery are some of the most common post transaction services offered by retailers.

Handling customer complaints effectively can have a very positive impact even on the most dissatisfied customers. "Goods once sold will not be taken back or exchangted", "Merchandise sold is exchanged during week days from 1pm to 3pm, subject to the condition of the merchandise" are the most commonly found tag lines in fine print on the invoice of any merchandise purchased. Handling merchandise returns and exchanges is the most important post transaction service. Home delivery, though an expensive post transaction service is being offered by an increasing number of retailers to increase customer satisfaction.

3.6.2 Customer evaluation of service quality:

While evaluating the services provided by retailers, customers compare the services they receive with the services expected by them. When the services received meet or exceed the services expected, customers are satisfied. However, they are dissatisfied when the services received by them do not match their service expectations. Expectations are based on the knowledge and experience of customers. Expectation can vary from customer to customer and from retailer to retailer.

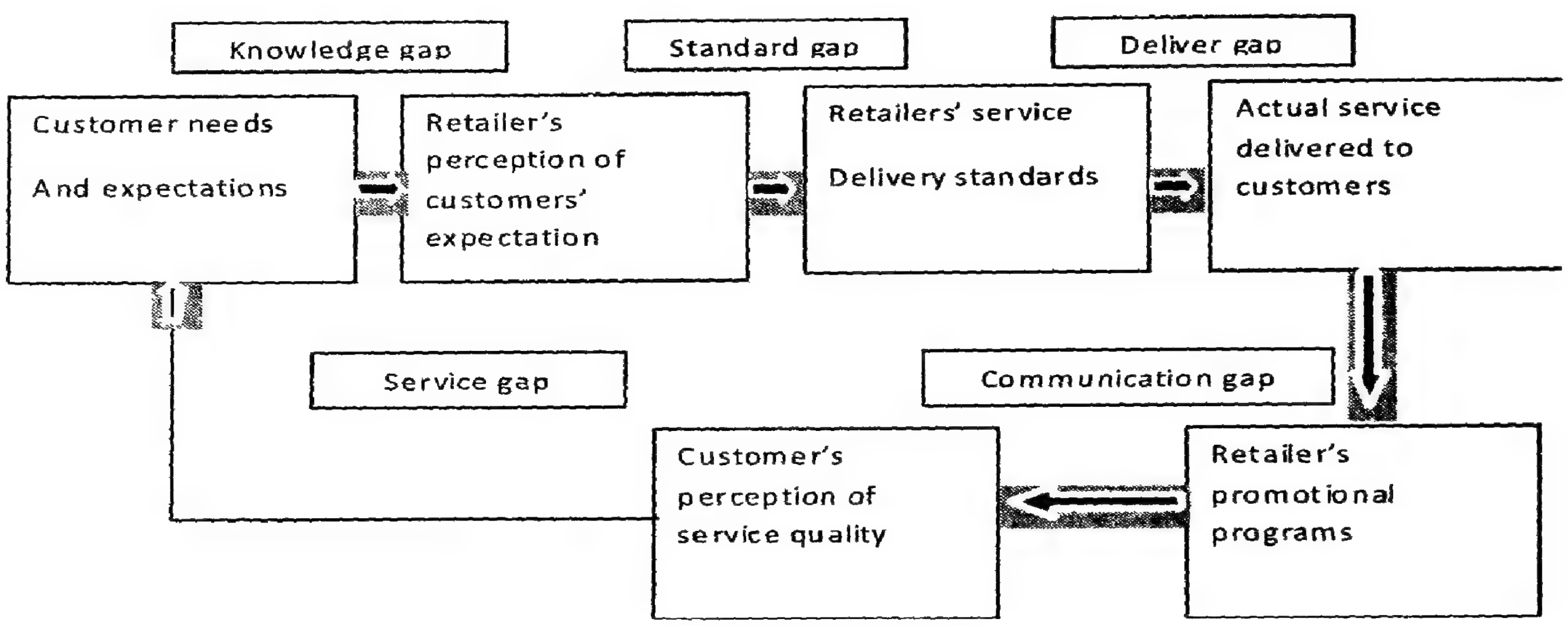
A customer who may satisfy with a low level of service at a retail outlet may not be satisfied with high service levels of another retailer. For example, though the actual service offered by Wal-Mart is lower than the service expected from a typical departmental

store, the customers are satisfied by the service provided by Wal-Mart. At every store, one of its employees stands at the entrance to greet the customers and answer their queries.

The evaluation of the service offered by a store usually depends on perceptions of customers. Through perceptions are influenced by the services actually provided, accurate evaluation of a service is difficult as it is intangible. Sales personnel are the major determinants of the customer's perception of service provided by the retailer. The satisfaction or dissatisfaction of customer arises from the gap between the perceived service and the actual service provided.

3.6.3 The GAPS model for improving quality of customer service:

The Gaps model for improving the quality of service was given by Valerie Zenthaml and the center for retailing studies at the Texas A&M University. This model gives insights into the various obstacles that may hinder a retailer's ability to close or otherwise minimize the gap between the customers' expectations and the perceived service (the customer's perception of the actual service received). For example, the level of service expectations from a fast food outlet will certainly be different from that of a restaurant at a star hotel.



There are many factors that influence the customers' expectations. They include advertising and sales promotions, personal needs, word-of-mouth publicity and competitive offerings. There are four key potential gaps that a retailer should understand in order to evaluate the service satisfaction.

a) Knowledge gap:

Retailers should have complete knowledge of customer expectations from a store. Acquiring this knowledge can be as simple as interacting with customers on a regular basis or it can be complex as conducting through research on customers. Some retailers develop programs for analyzing the service expectations and perceptions of their customers. These programs usually involve getting questionnaires filled up by customers visiting the

store and then analyzing them. Some retailers survey customers immediately after closing the transaction. In some stores managers interact with a panel of customers who share their experiences at the store while shopping and give suggestions for improving the services. Complaints form another important source of information about the quality of service at a retail outlet. Sales personnel and other staff members, who interact with customers on a regular basis usually, know a lot about the service expectations and perceptions of customers. This information can be accessed only if there is an open channel of communication across the retail organization.

b) Standards gap:

Apart from understanding customer needs, retailers should also set some service standards. Clearly defined service quality standards help employees understand how the company and its customers define a quality job. In order to close the standards gap, retailers should focus on

i) Providing high service quality

ii) Providing innovative solutions to various service related issues;

iii) Defining and describing the role of people delivering the service

iv) Establishing service objectives; and

v) Measuring the performance of the service.

c) Delivery gap:

In order to minimize or close the delivery gap and deliver services that exceed the set standards, retailers should provide employees with the necessary knowledge and skills, material and emotional support, and empower them to act in the best interests of customers and the organization as a whole. The interpersonal skills of service providers should be improved and they should be trained in various customer-handling techniques. Service providers should also receive sufficient emotional support from their supervisors and co-workers. The quality of service can be improved by empowering the staff at the operational level of the organization to take important decisions.

d) Communication gap:

Retailers generally raise the expectations of their target customers through advertising and other forms of communication. If any of their communication channels raise customers expectations to unrealistic levels, the actual experience at the store will disappoint customers. Retailers can minimize the communication gap by making realistic commitments and managing customer expectations.

There should be a clear line of communication between the marketing department and operations department since the marketing department develops the advertisements while the operations department delivers the service. Any miscommunication between these two departments would lead to a mismatch between the promises made through the advertisements and the services actually delivered.

possible, as he occupied immediately before the loss. The effect of this principle is to prevent the insured from making a profit out of his loss or gaining any benefit or advantage.

The object of a contract of insurance is to protect the financial interest of the insured in the subject matter of insurance. If the insured could recover any amount in excess of his loss, he would make a profit, and if this is permitted, there may be a temptation for the insured himself to bring about the losses so as to make a profit. This would be against public policy.

The measure of indemnity for loss of or damage to the insured property is generally the intrinsic market value of the property at the place and on the date of loss or damage.

CHECK YOR PROGRESS
2.Explain the Principle of Indemnity

However, the insurer's liability is subject to several limitations, some of which are mentioned below:

(i) Every policy of insurance contains a sum insured which is the maximum limit of liability under the policy. The amount is no the agreed value of the property (except under valued policies) nor is it the amount which will be automatically paid in the event of loss or damage. The amount payable under the insurance contract is the actual loss or the sum insured whichever is less.

(ii) The property insurances are generally subject to the conditions of average, and if there has been under insurance, only that portion of the loss is payable, which the sum insured bears to the market value of insured property at the time of loss.

(iii) Some policies are subject to 'excess' or 'franchise' which means that under certain circumstances, a part of the loss may have to be borne by the insured. In these circumstances, the insurer's liability is the measure of indemnity determined as above, less the amount of 'excess' or 'franchise'.

The difference between 'excess' and 'franchise' should be clearly understood. In either case, if the loss does not reach the limit, it is not payable at all; if it exceeds the limit, the excess only is payable under the 'excess' clause and the entire loss is payable under the 'franchise' clause.

For example, if there are two insurance policies 'A' and 'B', policy 'A' subject to an excess of Rs.1000/- and policy 'B' subject to a franchise of Rs.1000/-, and if a loss of Rs.500/- is reported under each policy, nothing will be payable under both policies. If however, the loss under each policy was Rs.1100/-, policy 'A' will pay Rs.100/- but policy 'B' will pay Rs.1100/-.

(iv) Property which is partially saved from loss or damage is called salvage. If a motor car is damaged to such an extent that it is not worthwhile to repair it, because the cost of repairs would exceed the sum insured or its value, in such cases the insurers would settle it as a constructive total loss and take over the salvage. If the salvage is left to the insured, to that extent he would be benefited which is against the principle of indemnity.

CHECK YOUR PROGRESS

3.Explain the Principle of Subrogation

6. 5. PRINCIPLE OF SUBROGATION

Subrogation may be defined as the transfer of rights and remedies of the insured to the insurer who has indemnified the insured in respect of the loss. If the insured has any rights of action to recover the loss from any third party, who is primarily responsible for the loss, the insurer, having paid the loss, is entitled to avail himself of these rights to recover the loss from the third party. The effect is that the insured does not receive more than the actual amount of his loss and any recovery effected from the third party goes to the benefit of the insurer to reduce the amount of his loss.

The principle of subrogation arises from the principle of indemnity. To allow the insured to collect the claim from the insurers and then collect again from the person responsible for the loss would be contrary to the principle of indemnity. He would then, be clearly making a profit out of the misfortune, and that would defeat the principle of indemnity. Common law has, therefore, evolved the doctrines of subrogation and contribution as corollaries of indemnity.

The doctrine may be illustrated by the following examples:

(a) Insured property may be destroyed by fire caused by the negligence of a third party who is at law responsible to make good the loss. The insurer having

NOTES

indemnified the insured is entitled to the insured's right of recovery against the third party.

(b) If cargo is damaged due to the negligence of a carrier (e.g., railways, truck, operators, shipping companies, etc.) who have an obligation to make good the loss of the insured, the benefit of this obligation passes to the insurer.

(c) A private car may be damaged in a collision caused by the rash and negligent driving of a truck. The private car owner's right of recovery against the truck owner is transferred to the insurer who has indemnified the loss.

(d) Under products liability policies, if a retailer is indemnified in respect of a claim preferred against him for a defective product, the insurer can recover from the wholesaler or manufacturer who supplied the product, if liability can be established against him.

(e) Under fidelity guarantee policy, the insurer after payment of the loss, is entitled to claim reimbursement from the defaulting employee.

CHECK YOUR PROGRESS

4. Explain the Principle of Proximity Clause

The right of subrogation is implied in all contracts of indemnity. In other words its application to contracts of indemnity is automatic without any express condition in the contract. It arises, however, only after payment of a loss. Marine insurance policies are subject to the doctrine of subrogation, but the policies do not contain any condition, and the insurers are subrogated to the rights of the insured only after payment of claim. Personal accident insurance policies are not contracts of strict indemnity, and hence the doctrine of subrogation does not apply to these policies.

Fire and miscellaneous policies contain an express condition to the effect that the right of subrogation can be exercised by the insurer even before payment of a claim. In certain circumstances, it becomes necessary to take action immediately against a third party in order to ensure that the rights of recovery are prejudiced by any delay. Delay may render the right of action useless by reason of the law of limitation which prescribes certain time limits for effecting recoveries.

6.6 DOCTRINE OF PROXIMITY CLAUSE

The object of insurance is to provide indemnity for such losses as are caused by insured perils. If stocks are burnt, then the cause of loss is fire which is covered under a

fire policy and hence the claim is payable. If stocks are stolen, the loss is not payable under the fire policy, as 'burglary' is not a peril covered. If the stocks are burnt by a bomb dropped by an enemy country, then the loss is caused by war which is an excluded peril and hence not payable under the standard fire policy. Thus, it is important to determine the cause of loss to decide whether the loss is payable or not.

There is no liability for a loss caused by an insured peril or an excluded peril.

If the loss is brought about only by one event, it would be no problem to decide the question of liability. But in actual situations, the loss may be the result of two or more causes, acting simultaneously or one after the other. Then, it becomes necessary to choose the most important, the most effective, the most powerful cause which has brought about the loss. This cause is termed the 'proximity cause', all other causes being considered as 'remote'.

6.7 TARIFF ADVISORY COMMITTEE

CHECK YOUR PROGRESS

5. What is the T.A.C?

In terms of Section 64U of the Insurance Act, 1938, "there shall be established a Committee, to be called the Tariff Advisory Committee to control and regulate the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business". As per the Insurance Act, the T.A.C. consists of the Chairperson of the IRDA (ex-officio) who will be the Chairman of the TAC, a senior officer of the IRDA who will be the Vice-Chairman, not more than ten members representing of Indian insurers and four representatives insurers incorporated or domiciled outside India, but registered in India. The rates, advantages, terms and conditions offered by the insurers will have to be as regulated by the TAC. Unless exempted specifically, for any class of business for such time as may be specified, the rates, terms, etc., determined by the TAC are binding on all insurers. Every decision of the TAC, is valid only after, and to the extent that, it has been ratified by the IRDA.

The TAC can require any insurer to supply to it any information to enable it to discharge its functions. The TAC can also depute any person to make a personal inspection of books and documents of the insurer to verify the accuracy of information supplied by the insurer. These powers enable the TAC to have adequate and reliable data

NOTES

on the experience of the insurers so that the rates fixed may be appropriate to the conditions in the Indian market. The data base is extremely important for rate fixing. The TAC does not have any data of its own. It depends on the insurer to supply it with accurate, reliable and complete information on the experience.

6.8. CONTRACT OF INSURANCE

When the insured pays the premium and the insurer accepts the risk, the contract of insurance is concluded. The policy issued by the insurer is the evidence of the contract.

Like any other contract, the contract of insurance is completed when on party accepts the offer made by the other party. The offer usually comes from the proposer and the offer is known as the proposal. Insurers indicate acceptance by the issue of a cover note or a letter of acceptance. In the latter event, the acceptance letter becomes another offer which is accepted by the payment of premium by the insured.

No contract is valid unless there is due consideration. Consideration is the "act or promise offered by the one party and accepted by the other as the price of that other's promise". In the case of insurance contracts 'premium' is the consideration from the insured and the 'promise to indemnify' is the consideration from the insurer.

Both parties should be of the same mind. In other words, there must be consent arising out of common intention. For example, if the proposer desired fire insurance, and the insurers issue a burglary policy, there is no consent arising out of common intention.

The persons to the contract should e competent to contract. Minors and persons of unsound mind cannot enter into insurance contracts. The legal capacity of an insurer to contract has to be explicit in its Memorandum and Articles of Association.

The object of the contract must be legal and not against public policy. For example, stolen goods cannot be insured. Insurance of smuggling ventures would be regarded by courts as opposed to public policy.

6. 9. LIFE INSURANCE CONTRACTS

A life contract is a contract, in terms of the Indian Contract Act, 1872. A contract is an agreement between two or more parties to do, or not to do, so as to create a legally binding relationship. A simple contract must have the following essentials:

- Offer and acceptance
- Consideration
- Capacity to contract
- Consensus 'ad idem' (genuine meeting of minds)
- Legality of object or purpose
- Capability of performance
- Intention to create legal relationship

Insurance is a specialized type of contract. Apart from the usual essentials of a valid contract, insurance contracts are subject to two additional principles viz. Principle of Utmost Good Faith & Principle of Insurable Interest These apply to all insurances, both life and non-life.

ANSWERS TO CHECK YOUR PROGRESS

1. The owner of property has a right under law to effect insurance on the property if he is likely to suffer financially when the property is lost or damaged. This legal right to insure is called insurable interest.
2. The principle of indemnity arises under common law and requires that an insurance contract should be a contract of indemnity only and nothing more. The object of the principle is to place the insured after a loss in the same financial position as far as possible, as he occupied immediately before the loss. The effect of this principle is to prevent the insured from making a profit out of his loss or gaining any benefit or advantage.
3. Subrogation may be defined as the transfer of rights and remedies of the insured to the insurer who has indemnified the insured in respect of the loss. If the insured has any rights of action to recover the loss from any third party, who is primarily responsible for the loss, the insurer, having paid the loss, is entitled to avail himself of these rights to recover the loss from the third party. The effect is that the insured does not receive

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more than the actual amount of his loss and any recovery effected from the third party goes to the benefit of the insurer to reduce the amount of his loss.

4. The object of insurance is to provide indemnity for such losses as are caused by insured perils. If the loss is brought about only by one event, it would be no problem to decide the question of liability. But in actual situations, the loss may be the result of two or more causes, acting simultaneously or one after the other. Then, it becomes necessary to choose the most important, the most effective, the most powerful cause which has brought about the loss. This cause is termed the 'proximity cause', all other causes being considered as 'remote'.
5. In terms of Section 64U of the Insurance Act, 1938, "there shall be established a Committee, to be called the Tariff Advisory Committee to control and regulate the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business".

6.10. REVIEW QUESTIONS

a) Explain the Principle of Insurable Interest
b) Explain the Principle of Utmost Good Faith
c) Explain the Principle of Indemnity
d) Explain the Principle of Subrogation
e) Explain the Principle of Proximity Clause
f) What is the T.A.C? What are its functions?

UNIT 7

LIFE INSURANCE

NOTES

7. 1. INTRODUCTION

Life insurance is a contract that pledges payment of an amount to the person assured (or his nominee) on the happening of the event insured against.

The contract is valid for payment of the insured amount during:

- The date of maturity, or

- Specified dates at periodic intervals, or
- Unfortunate death, if it occurs earlier.

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Among other things, the contract also provides for the payment of premium periodically to the Corporation by the policyholder. Life insurance is universally acknowledged to be an institution, which eliminates 'risk', substituting certainty for uncertainty and comes to the timely aid of the family in the unfortunate event of death of the breadwinner.

By and large, life insurance is civilisation's partial solution to the problems caused by death. Life insurance, in short, is concerned with two hazards that stand across the life-path of every person:

CHECK YOUR PROGRESS

1. What is the importance of application form?

1. That of dying prematurely leaving a dependent family to fend for itself.
2. That of living till old age without visible means of support.

7.2. LIFE INSURANCE VS. OTHER SAVINGS

a. Contract of Insurance:

A contract of insurance is a contract of utmost good faith technically known as uberrima fides. The doctrine of disclosing all material facts is embodied in this important principle, which applies to all forms of insurance

At the time of taking a policy, policyholder should ensure that all questions in the proposal form are correctly answered. Any misrepresentation, non-disclosure or fraud in any document leading to the acceptance of the risk would render the insurance contract null and void.

b Protection:

Savings through life insurance guarantee full protection against risk of death of the saver. Also, in case of demise, life insurance assures payment of the entire amount

assured (with bonuses wherever applicable) whereas in other savings schemes, only the amount saved (with interest) is payable.

c. Aid to Thrift:

Life insurance encourages 'thrift'. It allows long-term savings since payments can be made effortlessly because of the 'easy installment' facility built into the scheme. (Premium payment for insurance is either monthly, quarterly, half yearly or yearly). For example: The Salary Saving Scheme popularly known as SSS, provides a convenient method of paying premium each month by deduction from one's salary. In this case the employer directly pays the deducted premium to LIC. The Salary Saving Scheme is ideal for any institution or establishment subject to specified terms and conditions.

d Liquidity:

In case of insurance, it is easy to acquire loans on the sole security of any policy that has acquired loan value. Besides, a life insurance policy is also generally accepted as security, even for a commercial loan.

e Tax Relief:

Life Insurance is the best way to enjoy tax deductions on income tax and wealth tax. This is available for amounts paid by way of premium for life insurance subject to income tax rates in force. Assessees can also avail of provisions in the law for tax relief. In such cases the assured in effect pays a lower premium for insurance than otherwise.

f Money When You Need It:

A policy that has a suitable insurance plan or a combination of different plans can be effectively used to meet certain monetary needs that may arise from time-to-time. Children's education, start-in-life or marriage provision or even periodical needs for cash over a stretch of time can be less stressful with the help of these policies. Alternatively, policy money can be made available at the time of one's retirement from service and used for any specific purpose, such as, purchase of a house or for other

investments. Also, loans are granted to policyholders for house building or for purchase of flats (subject to certain conditions).

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7.3.HISTORY OF LIFE INSURANCE

Life Insurance in its modern form came to India from England in the year 1818. Oriental Life Insurance Company started by Europeans in Calcutta was the first life insurance company on Indian Soil. All the insurance companies established during that period were brought up with the purpose of looking after the needs of European community and Indian natives were not being insured by these companies. However, later with the efforts of eminent people like Babu Muttylal Seal, the foreign life insurance companies started insuring Indian lives. But Indian lives were being treated as sub-standard lives and heavy extra premiums were being charged on them. Bombay Mutual Life Assurance Society heralded the birth of first Indian life insurance company in the year 1870, and covered Indian lives at normal rates. Starting as Indian enterprise with highly patriotic motives, insurance companies came into existence to carry the message of insurance and social security through insurance to various sectors of society. Bharat Insurance Company (1896) was also one of such companies inspired by nationalism. The Swadeshi movement of 1905-1907 gave rise to more insurance companies. The United India in Madras, National Indian and National Insurance in Calcutta and the Co-operative Assurance at Lahore were established in 1906. In 1907, Hindustan Co-operative Insurance Company took its birth in one of the rooms of the Jorasanko, house of the great poet Rabindranath Tagore, in Calcutta. The Indian Mercantile, General Assurance and Swadeshi Life (later Bombay Life) were some of the companies established during the same period. Prior to 1912 India had no legislation to regulate insurance business. In the year 1912, the Life Insurance Companies Act, and the Provident Fund Act were passed. The Life Insurance Companies Act, 1912 made it necessary that the premium rate tables and periodical valuations of companies should be certified by an actuary. But the Act discriminated between foreign and Indian companies on many accounts, putting the Indian companies at a disadvantage.

The first two decades of the twentieth century saw lot of growth in insurance business. From 44 companies with total business-in-force as Rs.22.44 crore, it rose to 176 companies with total business-in-force as Rs.298 crore in 1938. During the mushrooming of insurance companies many financially unsound concerns were also floated which failed miserably. The Insurance Act 1938 was the first legislation governing not only life insurance but also non-life insurance to provide strict state control over insurance business. The demand for nationalization of life insurance industry was made repeatedly in the past but it gathered momentum in 1944 when a bill to amend the Life Insurance Act 1938 was introduced in the Legislative Assembly. However, it was much later on the 19th of January, 1956, that life insurance in India was nationalized. About 154 Indian insurance companies, 16 non-Indian companies and 75 provident were operating in India at the time of nationalization. Nationalization was accomplished in two stages; initially the management of the companies was taken over by means of an Ordinance, and later, the ownership too by means of a comprehensive bill. The Parliament of India passed the Life Insurance Corporation Act on the 19th of June 1956, and the Life Insurance Corporation of India was created on 1st September, 1956, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost.

LIC had 5 zonal offices, 33 divisional offices and 212 branch offices, apart from its corporate office in the year 1956. Since life insurance contracts are long term contracts and during the currency of the policy it requires a variety of services need was felt in the later years to expand the operations and place a branch office at each district headquarter. Re-organization of LIC took place and large numbers of new branch offices were opened. As a result of re-organisation servicing functions were transferred to the branches, and branches were made accounting units. It worked wonders with the performance of the corporation. It may be seen that from about 200.00 crores of New Business in 1957 the corporation crossed 1000.00 crores only in the year 1969-70, and it took another 10 years for LIC to cross 2000.00 crore mark of new business. But with re-organisation happening

in the early eighties, by 1985-86 LIC had already crossed 7000.00 crore Sum Assured on new policies.

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Today LIC functions with 2048 fully computerized branch offices, 109 divisional offices, 8 zonal offices, 992 satellite offices and the corporate office. LIC's Wide Area Network covers 109 divisional offices and connects all the branches through a Metro Area Network. LIC has tied up with some Banks and Service providers to offer on-line premium collection facility in selected cities. LIC's ECS and ATM premium payment facility is an addition to customer convenience. Apart from on-line Kiosks and IVRS, Info Centres have been commissioned at Mumbai, Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, New Delhi, Pune and many other cities. With a vision of providing easy access to its policyholders, LIC has launched its SATELLITE SAMPARK offices. The satellite offices are smaller, leaner and closer to the customer. The digitalized records of the satellite offices will facilitate anywhere servicing and many other conveniences in the future.

LIC continues to be the dominant life insurer even in the liberalized scenario of Indian insurance and is moving fast on a new growth trajectory surpassing its own past records. LIC has issued over one crore policies during the current year. It has crossed the milestone of issuing 1,01,32,955 new policies by 15th Oct, 2005, posting a healthy growth rate of 16.67% over the corresponding period of the previous year.

7.4. PRODUCT OF LIC

Life insurance products are usually referred to as 'plans' of insurance. These plans have two basic elements. One is the 'Death Cover' providing for the benefit being paid on the death of the insured person within a specified period.

Plans of insurance that provide only death cover are called 'Term Assurance' plans. Those that provide only survival benefits are called 'Pure endowment' plans. If the insured does not die within the specified period, no payment is made under a term assurance plan. Similarly, if the insured dies within the specified period, no payment is made under a pure endowment plan. Both these are like Fire Insurance policies. If the

specified contingency does not happen, the policyholder does not get anything from the insurer.

NOTES

All insurance plans are combinations o these two basic plans. A Term Assurance plan with an unspecified period is called a 'Whole Life Policy' under which the Sum Assured(SA) is paid on death, whenever it may occur. A Term Assurance plan along with a Pure Endowment Plan when offered as a single product is called and Endowment Assurance Plan, under which the SA is paid n survival of the specified period or on earlier death. A Term Assurance Plan with a pure Endowment Plan of double the value is called a Double Endowment Assurance plan under which the amount payable on survival is double the amount payable on death. What is called a Money Back or Anticipated Endowment Policy, under which, say 20% of SA is paid on survival every five years and 40% on survival for 20 years and full SA on death at any time within the 20 years, is effectively a combination of a Term Assurance Plan for 20 years for full SA and 4 different Pure Endowment Plans (20% SA for 5 years, 20% SA for 10 years, 20% SA for 15 years and 40% SA for 20 years).

A plan of assurance will have the following features. By making changes in these features or adding and combining some of them, any number of plans can be developed.

- Who can be insured? The various possibilities are (i) individual adults (ii) children (minors) (iii) two or more persons jointly under one policy
- What can be the SA? Some plans stipulate a minimum SA. There are maximum limits also for certain benefits, like accident benefits.
- In what contingency would the SA be payable? Could be on death or on survival.
- When would the SA be payable? On the contingency happening or on some other dates.
- How would the SA be payable? Could be in one lump sum or in installments.
- What would be the term (duration) of the policy? This determines the period during which the specified event should occur for the SA to be payable. Some plans provide for benefits even beyond the term.

- When would the premium be payable? Variations are in the frequency of payment (monthly, quarterly, half-yearly or yearly), as well as the period during which it is payable. Some plans provide for premiums to be paid for a period less than the term.
- Does the SA increase? This can happen because of participation in surpluses and bonus additions or because of guaranteed increases in SA.
- Does the SA reduce? This can also happen if the plan is to meet reducing liabilities under a mortgage.
- Are there additional benefits? These, also called supplementary benefits, may be provided by way of riders, in addition to the basic covers.

Convertible plans of assurance are plans, which provide, in its terms and conditions, that it can be changed to another plan after, or within a certain period after commencement. The advantage of such plan is that, when the right of conversion is exercised, there would be no further underwriting decision to be made. There would be no medical examination at that time. So, even if the insured has an adverse medical condition at the time, the policy of his choice would not be denied to him.

Such policies are usually taken by persons in the early stages of their careers, who expect their financial conditions to improve soon, but would not like to delay the benefits of insurance till then.

'Without profit' or 'non participating' policies are not entitle to bonuses declared after valuations. 'With profit' or 'participating' policies pay a slightly higher premium for the right to participate in the progress of the insurer. 'With profit' policies are popular with the because the bonuses are expected to be more than the extra premium paid. 'With profit' policies, where premium is payable for a limited period, will continue to participate even after the premiums have ceased.

Two or more lives can be covered under one policy. Policies usually cover married couples or partners. The SA is paid on the death of any of the insured persons during the term or at the end of the term. Some plans also provide payment of SA on the death of one life and the policy is continued to cover the second life till maturity without payment of further premium.

In the case of joint life insurances:

- A joint life declaration is necessary to create a joint interest in the policy.
- In case of partnership insurance, the partnership deed will be examined to ascertain the nature of financial interest of each partner.
- Each life will be underwritten separately.
- Bonuses accrue on the single basic SA only.

Insurance can also be taken on the lives of children, who are not majors. The proposal will have to be made by a parent or a guardian.

Annuities are the reverse of 'life insurance'. In annuity contracts, a person agrees to pay to the insurer a specified capital sum in return for a promise from the insurer to make a series of payments to him so long as he lives, while in insurance, the insured pays a series of payments in return for a promise to pay a lump sum on his death. Theoretically, under a life insurance contract, the insurer starts paying upon the death of the insured but under an annuity contract, the insurer stops paying upon the death of the annuitant.

In actual practice, however, there are many variations. The insured does not have to pay in a lump sum. He can pay in installments. The annuity does not have to stop on death. It can continue beyond.

Practically no underwriting is done in annuities. In fact, annuitants are supposed to exercise self-selection. Therefore, medical examination of annuitants is not insisted upon. The risk, that is to be covered, under annuities, is of living too long.

7.5. PREMIUM CALCULATION

The following illustrations are based on certain assumptions with regard to practices of insurers. These assumptions are specified at the appropriate places. While making calculations for any policy, the practices of that insurer must be conformed to.

Step 1: Find out tabular premium i.e.. Premium quoted in published premium rates for given age (nearer, next or last birthday as the case may be) for the relevant plan and term. This premium is per thousand sum assured. Assume that the figure is Rs. 45.60

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CHECK YOUR PROGRESS

2. What are the factors determining the amount of premium payable?

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Step 2: Deduct adjustment for large sum assured, if applicable, assuming that the insurer allows rebates as follows

Rebate per thousand	SA
Rs.25000 – Rs.49999	Re.1/-
Rs.50000 – Rs.99999	Re.1.50/-
Rs.100000 and over	Rs.2/-

If this is a policy for Rs.75000 SA, the premium would be Rs.44.10 (45.60 less 1.5)

Step 3: Make adjustment fro mode of payment of premium. Assuming that the insurer provides rebates of 1% for yearly mode and that the mode proposed in this case is yearly. the premium would decrease by 1% of 44.10 or Rs.0.44, making the premium Rs.43.66

Step 4: Add extras. Assuming that the extras in this case are Rs.1.50 per thousand for occupational hazard and Rs.2 per thousand for supplementary benefits, the total addition is Rs.3.50 making the total premium Rs.47.16

Step 5: Multiply by SA (Rs.47.16 X 75) equals Rs.3537.00

Note: If the adjustment of % for mode is made before the adjustment for SA, the deduction would have been 0.46, instead of 0.44. The difference can be significant, if the insurance is for a large SA. Insurers would clarify how they want it to be done.

The above calculation was made for yearly mode of premium. Therefore, the figure of 3537 is the premium to be charged. If however, the mode was quarterly, then the annual premium worked out by the above method, will have to be divided by 4 to determine the quarterly installment premium.

In the calculation shown in the earlier paragraph, the final figure arrived at has no paisa. If there are paise in the final figure, they may be (i) ignored or (ii) rounded off to the next higher integer, or (iii) rounded off to the nearest integer or (iv) rounded off to the nearest 50 paise or any other adjustment as the insurer may practice.

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7.6. SURRENDER VALUE

The surrender is a voluntary termination of the contract, by the policyholder. The policyholder can surrender the life insurance policy at any time be fore it becomes a claim. The amount payable on surrender is called the surrender value or cash value. Surrender values are published and made known to policyholders by some insurers either as part of the prospectus or by mention in the policy conditions. Some insurers prefer to announce a guaranteed surrender value as required by the law, which may be a given percentage of the premium paid. The actual surrender value will be better than the guaranteed surrender value.

The surrender value is usually a percentage of the premiums paid or a percentage of the paid up value. The percentage increases as the duration of the policy increases. The surrender value on a policy will be more after 15 years compared to the surrender value after 10 years. The percentage decreases as the original term of the policy increases. Between two policies of original term 20 and 30 years, both of which have been in force for the same 15 years, the surrender value on the former will be more than on the latter.

7.7. MORTALITY TABLE

In actuarial science, a life table (also called a mortality table or actuarial table) is a table which shows, for each age, what the probability is that a person of that age will die before his next birthday. From this starting point, a number of statistics can be derived and thus also included in the table:

- the probability of surviving any particular year of age
- remaining life expectancy for people at different ages
- the proportion of the original birth cohort still alive
- estimates of a cohort's longevity characteristics.

Life tables are usually constructed separately for men and for women because of their substantially different mortality rates. Other characteristics can also be used to distinguish different risks, such as smoking status, occupation, and socio-economic class.

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Life tables can be extended to include other information in addition to mortality, for instance health information to calculate health expectancy. Health expectancies, of which disability-free life expectancy (DFLE) and Healthy Life Years (HLY) are the best-known examples, are the remaining number of years a person can expect to live in a specific health state, such as free of disability. Two types of life tables are used to divide the life expectancy into life spent in various states: 1) multi-state life tables (also known as increment-decrement life tables) based on transition rates in and out of the different states and to death, and 2) prevelence-based life tables (also known as the Sullivan method) based on external information on the proportion in each state. Life tables can also be extended to show life expectancies in different labor force states or marital status states.

Life tables are also used extensively in biology and epidemiology. The concept is also of importance in product life cycle management.

7.8. INSURANCE APPLICATIONS

In order to price insurance products, and ensure the solvency of insurance companies through adequate reserves, actuaries must develop projections of future insured events (such as death, sickness, and disability). To do this, actuaries develop mathematical models of the rates and timing of the events. They do this by studying the incidence of these events in the recent past, and sometimes developing expectations of how these past events will change over time (for example, whether the progressive reductions in mortality rates in the past will continue) and deriving expected rates of such events in the future, usually based on the age or other relevant characteristics of the population. These are called mortality tables if they show death rates, and morbidity tables if they show various types of sickness or disability rates.

The availability of computers and the proliferation of data gathering about individuals has made possible calculations that are more voluminous and intensive than those used in the past (i.e. they crunch more numbers) and it is more common to attempt to provide different tables for different uses, and to factor in a range of non-traditional behaviors (e.g. gambling, debt load) into specialized calculations utilized by some

institutions for evaluating risk. This is particularly the case in non-life insurance (e.g. the pricing of motor insurance can allow for a large number of risk factors, which requires a correspondingly complex table of expected claim rates).

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7.9. RISK PREMIUM

This usually refers to a single premium that covers a specific risk for a specific period of time. For example, in pricing unit-linked contracts, a company will usually cost for death or sickness cover by applying a monthly risk premium to the appropriate amount at risk in each month.

The term is also used in reinsurance. Here, the risk premium is the amount required to cover the cost of the death sum at risk. It is basically of the form (SA - V)qx, plus expenses where SA = sum assured, V = reserve and qx = probability of dying for a life aged x.

A form of reinsurance called risk premium reinsurance involves a payment only of the risk premium to the reinsurer, and the payment of the sum at risk to the direct writer on the death of the policyholder.

7.10. FACTORS DETERMINING PREMIUM

The factors affecting risk on the life on\f an individual are called hazards. Hazards may be (i) Physical (ii) Occupational or (iii) Moral. Physical hazards are:

a) Age – As age increases, the probability of death increases. These probabilities are built into the mortality tables and thereby into the premium rates. The underwriter looks into the factor of age, mainly because of its relationship with other factors.

b) Sex – Mortality of female lives are seen to be more than male lives at younger ages, among the poorer and uneducated sections. Underwriting considerations are also different in female cases.

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c) Build – Build including height, weight, etc. may suggest tendencies towards cardiac and other ailments like diabetes or TB. Underwriters view variations from standard weights with care.

d) Physical conditions – The medical examination of reflexes, blood pressure, pulse rates, etc., provides data with regard to the condition of important systems of the body.

e) Physical impairments – Blindness, deafness, etc., and other conditions, which are not illnesses or degenerative, are hazards affecting the probabilities of death.

f) Personal history – This is important as pointers to the health as the life style of the person.

g) Family history – This is looked at to see whether the re is any hereditary factor that makes the person susceptible to illness. Family history of early deaths, of cardiac illnesses or diabetes, could be significant.

h) Occupational hazards arise out of one's job. The nature of the job or the place in which the job is done have effects on the worker. Contract with and inhalations of fumes, excessive temperatures, etc., affect health and life spans. Studies have identified occupations with various hazards and also tried to quantify the excess hazard, so that the underwriters can determine the appropriate extra premiums.

i) Moral hazard refers to the intentions of the proposer. If the proposal is being made because there is a genuine need for insurance, there is no moral hazard. If the intention is to seek undue advantage through the insurance policy, there is some moral hazard.

Moral hazard is not measurable. There is no test to establish it. It is a matter of opinion. If moral hazard is suspected, no amount of extra premium will be appropriate. Underwriters would hesitate to accept such proposals at any cost. But, they would like to be fairly certain before deciding so.

7.11. EXTRA PREMIUMS

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Extra premiums may be charged on any particular policy. This may happen because of the grant of some benefit in addition to the basic benefits under the plan, like accident benefit or premium waiver benefit. Riders provide additional or supplementary benefits. Extra premium may become chargeable because of underwriting decisions. If the risk of the life to be insured is assessed as more than normal because of health or because of nature of jobs or habits, underwriters may charge extra premiums. These are usually stated as say, Rs. 2 per thousand, and will be added to the premium otherwise changeable.

CHECK YOUR PROGRESS

3. Describe the concept of actuarial valuation

7.12. ACTUARIAL VALUATION

Premium is calculated taking into account likely future experience in respect of mortality, interest and expenses. These are assumptions or expectations. The future experience may or may not conform to these expectations. If they conform, the premium charged could be considered adequate and the business can be said to be properly funded. However, if the experience is worse than the expectations (mortality is more or interest earnings are less or expenses are more), then the premium would be found to be inadequate and the business could run into difficulties. The practice followed by all prudent insurers is that periodically, they check the validity of these assumptions to make sure that the business is on sound lines. The process of doing so is called an 'Actuarial Valuation'.

The Insurance Act in India requires that actuarial valuations be done every year. Prudence requires that the checking bed done as frequently as possible. Computers have made it possible to make the necessary calculations easily.

In a valuation, the actuary estimates the liability of the insurer in respect of the business in its books. He then estimates the amount of premiums that are due to be received in future, as these will add to the funds to meet the liability. The difference between the two is the fund that the insurer must have to remain solvent. If the fund is less, the insurer is not solvent. The method of estimating the liability of the business and of the future premiums, is very technical and complex, involving actuarial principles. It

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has to be done by an actuary with recognized professional qualifications. This is one of the reasons why every insurer has an actuary, wither as a full time employee or as a consultant.

The insurer is required to maintain separate funds in respect of non-participating policies and in respect of participating policies. Separate valuations will be made I respect of these two funds. If the valuation shows that the fund is more than the estimated liabilities, the insurer is said to have a surplus, which can be distributed in ways in which profit is distributed by companies. The entire amount may not be distributed. Some part may be kept back as reserves. However, the laws stipulate that in respect of the surplus in the fund for participating policies, not more than 10% of the surplus can be distributed to the shareholders. The rest will have to be distributed to the policyholders as bonus.

7.13. GROUP INSURANCE

CHECK YOUR PROGRESS

4. What are group insurance plans?

Group insurance is a plan of insurance, which provides power to a large number of individuals under a single poolicy called the 'Master Policy'. The insurance contract is with the body that represents the individuals,the employer or the association. Because the contract is with the body, that body is the policyholder. The individuals are the beneficiaries. The amount and terms of insurance are negotiated by the policy holder and not by the individual beneficiaries. The benefits will be determined on bases that apply uniformly to all the individuals.

The premium will be paid to the insurer by the policyholder, who may, or may not, collect the same from the individuals concerned. If the individuals contribute to the premium, that may be either full or partial. In many employer schemes, the entire premium is paid by the employer. Sometimes, employees are made to contribute part of the cost. If the premium is collected from the individuals concerned by an employer, the premium may be deducted from their salaries. That does not make this a policy under the Salary Savings Scheme, because of two basic differences. One is that the ownership of the policy is with tae employer and not the employee. Secondly, the extent of cover and the terms are determined by the employer and not by the individual.

As many persons are covered under one single contract, the administrative costs are low. Because the coverage is not at the choice of the individual concerned, the chance of an adverse selection is low. Therefore, the rules of medical examination are more liberal in the case of group insurance policies.

FEATURES:

- The most important requirement is that the group must not have been formed for the purpose of taking advantage f this scheme. The group must have some other bonding. Entry into or exit from the group must be for reasons other than the availability of cover under the scheme. Also, there must be a minimum number of members in the group. Twenty five would be considered adequate. In many cases, the members would be in hundreds.
- The individual beneficiary will not choose the amount of insurance cover. The amount will be determined on criteria which are applied uniformly to all the members of the group.
- The inclusion of members in the scheme also is a matter on which the member will have no choice. Everybody fulfilling specified criteria, will have to compulsorily join the group. These are methods to avoid adverse selection.
- Individual lives are not separately assessed for risks. The underwriting or selection is of the group as a whole. The health, morals or habits of any particular individual are not scrutinized.
- The premium under a group insurance policy will change from year to year. This is so because the number of persons covered would change because of exits (deaths, retirements, resignations) and new entrants. The amount of cover will also vary because of changes in age, income, rank, etc, of existing members.
- The premium may also change according to the mortality, experience of the group. If the experience is better than originally expected, the benefit of the favorable experience would be passed on to the policyholder, by way of reduction of premium. This system is called 'profit sharing'.

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PENSION PLANS:-

Employers who have to pay pensions purchase annuities from a life insurer as and when they have to release the pensions. After purchase, the annuities will be paid by the insurer directly to the pensioners. The benefits can be tailored to meet the requirements of the employer and the pensioners. The purchase price would be decided by the employer, according to its policies and terms of employment. Or a given purchase price there could be various options as to how the annuity could be dispersed. These could be left to the preference of the pensioner.

Voluntary Retirements Schemes are very common these days. Employees receive substantial amount from the employers. Group insurance schemes can help to channelise such funds to steady and assured flows of income.

HEALTH INSURANCE:-

Health insurance, is according to the laws in India, part of non life business. Therefore, life insurers will not be catering to the insurance needs relating to sickness, except to a limited extent as riders to individual life insurance policies. It cannot become the subject matter of a group insurance policy. However, if the law changes in conformity with the provisions in other countries, life insurers will find a very big scope for a new line of business, both in individual and group policies.

CLAIMS SETTLEMENT:-

A claim is the demand that the insurer should redeem the promise made in the contract. The insurer has then to perform his part of the contract that is, settle the claim, after satisfying himself that all the conditions and requirements for settlement of claim have been complied. In particular he should check:

- Whether insured event has taken place
- What are the obligations assumed under the contract, which are required to be performed? These may be payment of bonus, payment of sum assured in installments, waiver of future premiums, etc.

- Whether the policyholder has performed his part? The policy status with regard to premium position, age admission, outstanding loan and interest, survival benefits, if any, legal requirements such as under MUP Act, foreign exchange regulations, report of investigation, police reports, if any.
- Who are the persons entitled to demand performance? Nomination/assignment/income tax notice/prohibitory orders/official assignees notice-are all relevant.

7.14 ANSWERS TO CHECK YOUR PROGRESS

1. Any misrepresentation, non-disclosure or fraud in any document leading to the acceptance of the risk would render the insurance contract null and void.
2. The factors affecting risk on the life on\f an individual are called hazards. Hazards may be (i) Physical (ii) Occupational or (iii) Moral.
3. Premium is calculated taking into account likely future experience in respect of mortality, interest and expenses. These are assumptions or expectations. The future experience may or may not conform to these expectations. If they conform, the premium charged could be considered adequate and the business can be said to be properly funded.
4. Group insurance is a plan of insurance, which provides power to a large number of individuals under a single policy called the 'Master Policy'.

7.15. REVIEW QUESTIONS

1. What are the points of distinction between Term Assurance plans and Pure Endowment plans?
2. What are the steps to be followed in determining the amount of premium payable?
3. What are the factors determining the amount of premium payable?
4. Describe the concept of actuarial valuation
5. What are group insurance plans? Explain.

NOTES

UNIT 8

NON-LIFE INSURANCE

8.1. INTRODUCTION

Fire Insurance is designed to provide financial protection for property against loss or damage by fire and other specified perils.

a) Examples Of Insurable Property:-

- Buildings
- Electrical installation in buildings
- Machinery, plant and equipment, accessories, etc.
- Goods (raw materials, in process, semi finished, finished, packing materials, etc.) in factories, godowns.
- Goods in the open.
- Contents in dwellings, shops, hotels, etc.
- Furniture, fixture and fittings
- Pipelines (including contents) located inside or outside the compound, etc.

b) The Standard Fire And Special Perils Policy:-

8.2.STANDARD FIRE POLICY

NOTES

The perils specified in the policy

A. Fire

Excluding destruction or damage caused to the property insured by

(a) (i) its own fermentation, natural heating or spontaneous combustion.

(ii) its undergoing any heating or drying process.

(b) burning of property insured by order of any Public Authority

(Note: Spontaneous combustion can be covered as extra premium)

CHECK YOUR PROGRESS

1. What are the perils covered in fire policy?

B. Lightning

C. Explosion/Implosion

Excluding destruction or damage caused to the boilers (other than domestic boilers), economizers or other vessels in which steam is generated, machinery or apparatus subject to centrifugal force by its own explosion/implosion.

(Note: This risk can be covered by Boiler Explosion Policy in Engineering Insurance)

D. Aircraft Damage

Destruction or damage caused by aircraft, other aerial or space devices and articles dropped there from excluding those caused by pressure waves.

E. Riot, Strike, Malicious and Terrorism Damage

Direct visible physical loss, destruction or damage by external violent means caused to the property but excluding those caused by:

a. total or partial cessation of work or the retarding or interruption or cessation of any process or operations or omissions of any kind.

NOTES

b. Permanent or temporary dispossession resulting from confiscation, commandeering, requisition or destruction by order of the Government or any lawfully constituted authority.

c. Permanent or temporary dispossession of any building or plant or unit or machinery resulting from the unlawful occupation by any person of such building or plant or unit or machinery or prevention of access to the same.

d. Burglary, housebreaking theft, larceny or any attempt by any person taking part therein.

F. Storm, Cyclone, Typhoon, Tempest, Hurricane, Tornado, Flood and Inundation

G. Impact Damage

Impact by any Rail/Road vehicle or animal by direct contact not belonging to or owned by

Tthe insured or any occupier of the premises or

Their employees while acting in the course of their employment.

H. Subsidence and Landslide including Rock slide

Destruction or damage caused by Subsidence of part of the site on which the property stands or Land slide/Rock slide excluding:

a. The normal cracking, settlement or bending down of new structures.

b. The settlement or movement of made up ground.

c. Coastal or river erosion

d. Defective designs or workmanship or use of defective materials.

e. Demolition, construction, structural alterations or repair of any property or groundworks or excavations.

I. Bursting and/or overflowing of Water Tanks, Apparatus and Pipes

J. Missile Testing Operations

K. Leakage from Automatic Sprinkler Installations

Excluding destruction or damage caused by

f. Repairs or alterations to the buildings or premises.
g. Repairs, Removal or Extension of the Sprinkler Installation.
h. Defects in construction known to the insured.

L. Bush Fire

Excluding destruction or damage caused by Forest Fire.

As per the proviso, the liability of the company shall in no case exceed in respect of each item, the sum expressed in the schedule to be insured thereon or in the whole the total sum insured.

c) General Exclusions:-

The policy does not cover

(i) 5% of each and every claim resulting from the operation of Lightning/STFI/ Subsidence & Landslide including Rock Slide covered under the policy.
(ii) Loss, destruction or damage caused by war, and kindred perils.
(iii) Loss, destruction or damage directly or indirectly caused to the property insured by nuclear peril.
(iv) Loss destruction or damage caused to the insured property by pollution or contamination excluding

   a. pollution or contamination which itself results from a peril hereby insured against.
   b. Any peril hereby insured against which itself results from pollution or contamination.

(v) Loss, destruction or damage to bullion or unset precious stones, curios or works of art for an amount exceeding Rs.10000/-, manuscripts, plans, drawings, securities, obligations or documents of any kind, stamps, coins or paper money, cheques, books of accounts or other business books, computer systems records, explosives unless otherwise expressly stated in the policy.

(vi) Loss, destruction or damage to the stocks in Cold Storage premises caused by change of temperature.

(vii) Loss, destruction or damage to any electrical and/or electronic machine, apparatus, fixture or fitting (excluding fans and electrical wiring in dwellings) arising from or occasioned by over-running, excessive pressure, short circuiting, arcing, self-heating or leakage of electricity, from whatever cause (lightning included).

(viii) Expenses incurred on (a) Architects, Surveyors and Consulting Engineer's Fees and (b) Debris removal necessarily incurred by the insured following a loss, destruction or damage to the property insured by an insured peril in excess of 3% and 1% of the claim amount respectively.

(Note: Cover for expenses in excess of 3% and 1% can be arranged by endorsement)

An insurer is expected to insure his property for its full value. In the event of claim if it is found that he has not covered the property for its full value, then he has to bear a portion of the claim for his own account.

d) Example:-

Value of property	Rs.200000
Sum Insured	Rs.150000
Loss	Rs.80000

The amount payable $= \dfrac{150000 \times 80000}{200000} = \text{Rs.}60000$

e) Fire extinguishing appliances discount :-

The discount as per the scale may be granted by the insurers subject to the following:

a. System shall be erected and tested as per the relevant regulations of the TAC and certificate from professional(s)/professional agency(ies) confirming the efficiency of the system and its compliance with the rules shall be submitted by the insured.

b. The installation shall be maintained in efficient working order at all times and annual maintenance contract with an external agency shall be in force.

f) Consequential Loss (Fire) Insurance:-

Fire insurance is designed to provide protection in respect of loss of or damage to buildings, machinery, furniture and fittings, goods and merchandise, etc. by fire and allied perils. The insurance affords cover for 'material damage'. However an indemnity for the 'material damage' does not provide complete protection to the insured who may also suffer trading losses due to total or partial stoppage of the business.

The purpose of consequential loss or loss of profits insurance (also known as Business Interruption insurance) is, therefore, to make good these losses.

Where as the subject matter of the insurance is material property, the subject matter of profits insurance is the business of insured, that is, the earning capacity of the property. Fire insurance is concerned with the 'capital loss', i.e., loss of property; profit insurance is concerned with the 'revenue' loss, i.e., trading loss due to interruption of business as a result of an insured peril.

g) Basis of Loss of profit insurances:-

The profits of a business are related to the total income or turnover. If this is stopped or reduced, the profits are affected. Therefore, loss of profits is determined and

measured with reference to reduction in turnover and this is the basis usually adopted in profits insurance.

NOTES

8.3. MARINE INSURANCE

Marine insurance, the oldest branch of insurance, comprises (a) cargo insurance and (b) hull insurance.

Cargo insurance provides insurance cover in respect of loss or of damage to goods during transit by rail, road, sea or air. Thus cargo insurance concerns the following:

(i) export and import shipments by ocean-going vessels of all types,

(ii) coastal shipments by steamers, sailing vessels, mechanized boats, etc.,

(iii) shipments by inland vessels or country craft, and

(iv) consignments by rail, road, or air and articles sent by post.

Hull insurance, on the other hand, concerns the insurance of ships (hull, machinery, etc.).

Cargo insurance plays an important role in domestic trade as well as in international trade. Most contracts of sale require that the goods must be covered, either by the seller or the buyer, against loss or damage.

Type of contract	Responsibility for Insurance
Free on Board	The responsible till the goods are placed on board the steamer. The buyer is responsible thereafter. He can get the insurance done wherever he likes.
Free on Rail	The provisions are the same as above. This is mainly relevant to internal transactions.
Cost and Freight	Here also, the buyer's responsibility normally attaches once the goods are placed on board. He has to take care of the

	insurance from that point afterwards.
Cost, Insurance & Freight	In this case, the seller is responsible for arranging the insurance. He includes the premium charge as part of the cost of goods in the invoice.

A contract of sale involves mainly a seller and a buyer, apart from other associated parties like carriers, banks, clearing agents, etc. The question as to who is responsible for effecting insurance on the goods, which is the subject for sale, depends on the terms of the sale contract. The principal types of sale contracts, in so far as marine insurance is directly concerned, are as follows:

The normal practice in export/import trade is for the exporter to ask the importer to open a letter of credit with a bank in favor of the exporter. As and when the goods are ready for shipment by the exporter, he hands over the documents of title to the bank and gets the bill of exchange drawn by him on the importer, discounted with the process. In this process, the goods which are the subject of the sale are considered by the bank as physical security against the monies advanced by it to the exporter. A further security by way of an insurance policy is also required by the bank to protect its interests in the event of the goods suffering loss or damage in transit, in which case the importer may not make the payment. The terms and conditions of insurance are specified in the letter of credit.

8.4. MOTOR INSURANCE

Motor insurance accounts for a major portion of the miscellaneous premium income of insurance companies. This is a tariff class of business.

For purpose of insurance, motor vehicles are classified into three broad categories.

(a) Private cars

(b) Motor cycles and motor scooters

(c) Commercial vehicles, further classified into

 (i) Goods carrying vehicles

 (ii) Passenger carrying vehicles e.g.,

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- motorised rickshaws
- taxis
- buses

(iii) Miscellaneous vehicles, e.g.,
- hearses
- ambulances
- cinema film recording & publicity vans
- mobile dispensaries, etc.

Two types of losses arise in respect of motor vehicles: Loss of damage to the vehicle and third party liability.

8.5. ELECTRONIC EQUIPMENT POLICY

The term electronic equipment includes the entire computer system consisting of CPU, Keyboards, Monitors, Printers, UPS, System Software, etc. Auxiliary equipment such as air-conditioning, heating and power conversion, etc. are also covered.

Some examples of electronic equipment are:

Electronic data processing (EDP) equipments
Electro-medical equipment
Equipment for research and material testing
Telecommunication and navigational equipment
Computer system for production plant and machinery
Signal and transmitting units, etc.

The policy is available to the owner, lessor or hirer, depending upon the responsibility or liability in each case. This policy is divided into 3 sections

SECTION I :

Covers any unforeseen and sudden physical loss or damage to Electronic Equipment's from any cause, other than those excluded.

SECTION II :

Covers External Data Media and the expenses for reconstruction and re-recording of information.

SECTION III :

Covers Increased Cost of Working .

a) General Exclusions:-

- Acts of Terrorism
- War and Nuclear Risk
- Willful Act or Negligence
- Partial or Total Cessation of Work
- Loss or damage to the property falling under the terms of the Maintenance Agreement.
- Loss or destruction or damage directly occasioned by pressure wave caused by aircraft and other aerial devices
- Consequential Losses

b) Exclusions to Section I :-

- Loss or Damage caused by pre-existing faults or defects
- Normal wear and tear, erosion, corrosion, encrustation
- Any costs incurred in connection with the elimination of functional failures unless such failures were caused by an indefinable loss or damage
- Costs incurred in connection with the maintenance of the insured items
- Loss or damage to objects made of glass, porcelain or ceramics, sieves or any operating media
- Aesthetic defects such as scratches on painted, polished or enameled surfaces

b) Exclusions to Section II :

Costs arising from false programming, punching, labeling or inserting, inadvertent canceling of information or discarding of data media, and from loss of information aused by magnetic fields

c) Exclusions to Section III :-

Costs for replacement of data media, data and regeneration of data

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8.6 BURGLARY INSURANCE

Burglary Insurance policy covers property contained in business premises, stocks owned, or for which insured is responsible or held in trust and/or commission. It also covers cash, valuables, securities kept in a locked safe or cash box in locked steel cupboard on specific request.

a What does this Policy cover ?

This Burglary Insurance covers loss or damage caused by

- o Burglary and Theft (i.e. theft following upon an actual forcible and violent entry of and / or exit from the premises)
- o Robbery

In respect of contents of offices, warehouses, shops, etc. and cash in safe or strong room and also damage caused to the premises

b. Extensions :-

It is possible to extend the policy to include loss of the insured property to cover burglary as a result of riot & strike risks.

It is possible to extend the cover to include theft and larceny not accompanied by violent ingress or exit. The extension does not cover losses detected during routine stock taking/ checking.

The Policy does not cover loss or damage arising from

- War and warlike operation, Riot & strike, civil commotion, Terrorist activities conclusion of nature and / or Consequential loss by use of the keys to the safe unless obtained by force or threat
- Any inmate or member of the Insured's household or his business staff or any other person lawfully in the premises
- Ionizing radiation or contamination by radioactivity
- Nuclear weapons material

c Underwriting:-

A proposal is an application for an insurance cover. When a proposal is received, the insurer will not agree to grant the cover automatically. The insurer will make a decision as to the admissibility of the proposer to the pool of policyholders. This is because of the insurer's role as a trustee. It has to ensure that every new entrant into the pool has similar exposure to the risks as the others. This process of verifying the level of risk in each new entrant is called 'selection' or 'underwriting'.

The underwriting process is an important one in the life insurance office. If the risk is wrongly assessed, the premium charged would not be appropriate. A lower premium affects the solvency of the fund. The cost of the additional risk, not recovered from the proposer would have to be borne by the rest of the policyholders. That is not fair to them. A decision to charge a premium higher than necessary would not be fair to the proposer, because of the principle of utmost good faith. The selection has implications of fairness to the insurer and to policyholders, individually and collectively.

If the underwriter finds that the life proposed to be insured has no adverse features affecting mortality, it is considered as a normal or standard or first class life. The premium charged would be as per tabular rates. Otherwise, the terms of acceptance of the proposal would be different. In some cases, the insurer may refuse (decline) to grant insurance. The process of underwriting is therefore, very important.

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CHECK YOUR PROGRESS

2. Explain the process of underwriting

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The underwriter makes his decision on the basis of the following:

- The statements made by the proposer in the proposal form, which are assumed to be correct (principle of utmost good faith), providing data about himself and the person to be insured, habits and family history.
- Report of the medical examination.
- Report of the agent or other officials.

In the case of large SAs, the underwriter may ask for additional medical reports (special examination) or from senior officials (for moral hazard), as a matter of routine. The officials are expected to make enquiries about the life to be insured and the family, their occupations or businesses, their income levels and life styles, etc. Proof may also be sought to substantiate the reports. A report from the agent is a must in all cases. The report of the agent may be sufficient, if he is experienced enough.

8.7 ANSWERS TO CHECK YOUR PROGRESS

1. a.Fire, b. Lightning, c. Explosion/Implosion, d. Aircraft Damage, e. Riot, Strike, Malicious and Terrorism Damage, f. Storm, Cyclone, Typhoon, Tempest, g. Hurricane, Tornado, Flood and Inundation, h. Subsidence and Landslide including Rock slide Bursting and/or overflowing of Water Tanks, Apparatus and Pipes, i. Missile Testing Operations, j. Leakage from Automatic Sprinkler Installations, k.Bush Fire
2. A proposal is an application for an insurance cover. When a proposal is received, the insurer will not agree to grant the cover automatically. The insurer will make a decision as to the admissibility of the proposer to the pool of policyholders. This is because of the insurer's role as a trustee. It has to ensure that every new entrant into the pool has similar exposure to the risks as the others. This process of verifying the level of risk in each new entrant is called 'selection' or 'underwriting'.

8.8. REVIWE QUESTIONS

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a) Explain the Standard Fire Policy with mention of the perils covered and the general exclusion.

b). Explain the Marine Insurance Policy and its types

c). Explain the process of underwriting

d). Explain the Electrical Equipments Policy

e). Explain Burglary Insurance

NOTES

UNIT 9

RISK MANAGEMENT PROCESS

CHECK YOUR PROGRESS

1. Risk management function involves in how many processes?

9.1.INTRODUCTION

Risk management is the systematic process of managing an organization's risk exposures to achieve its objectives in a manner consistent with public interest, human safety, environmental factors, and the law. It consists of the planning, organizing, leading, coordinating, and controlling activities undertaken with the intent of providing an efficient pre-loss plan that minimizes the adverse impact of risk on the organization's resources, earnings, and cash flows.

9.2 RISK MANAGEMENT PROCESS

Just as the finance and marketing functions are applications of management processes and techniques to specialized problems and in fact grew out of the general field

of management, risk management also involves the application of general management processes and techniques to the specialized problems of risk control and risk finance. There is general agreement that the risk management function involves four interrelated processes:

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(1) Systematic and continuous investigation of risk loss exposures,

(2) Evaluation of their nature, frequency, severity, and the potential impact on the organization,

(3) Planning and organizing of appropriate risk control and risk financing techniques to efficiently minimize loss impacts on the organization,

(4) Implementation of such techniques both internally at the department and top management levels, and externally with loss control organizations, insurers, and other risk finance specialists.

The risk manager is mostly a planner, promoter, and coordinator of the above processes. Responsibility for implementation resides at the departmental level. Accidents, injuries, fires, thefts, defective products, violations of employee rights, and environmental pollution occur at the worksite and can best be prevented or reduced at that level. Such prevention will not occur, however, without guidance by knowledgeable experts like risk managers and loss control specialists.

3 PERCEPTION OF RISK

Risk perception is the subjective judgment that people make about the characteristics and severity of a risk. The phrase is most commonly used in reference to natural hazards and threats to the environment or health, such as nuclear power. Several theories have been proposed to explain why different people make different estimates of the dangerousness of risks. Three major families of theory have been developed: psychology approaches (heuristics and cognitive), anthropology/sociology approaches

CHECK YOUR PROGRESS

2. What are the 3 theories for perception of risk?

1.Heuristics and congnitive

2.Cultural theory

3.Social amplification of risk framework

(cultural theory) and interdisciplinary approaches (social amplification of risk framework).

NOTES

9.4 THREAT ANALYSIS

- What is threat analysis?
  - Potential Attacks/Threats/Risks
  - Analysis
  - Countermeasures
  - Future Preparations

9.5 EVENT ANALYSIS

An Event study is a statistical method to assess the impact of an event on the value of a firm. For example, the announcement of a merger between two business entities can be analyzed to see whether investors believe the merger will create or destroy value. The basic idea is to find the abnormal return attributable to the event being studied by adjusting for the return that stems from the price fluctuation of the market as a whole.[1] Event studies have been used in a large variety of studies, including mergers and acquisitions, earnings announcements, debt or equity issues, corporate re-organisations, investment decisions and corporate social responsibility

9.6 SAFETY AUDIT

The role of Internal Audit is likely to differ from one organisation to another. In practice. Internal Audit's role may include some or all of the following:

- focusing the internal audit work on the significant risks, as identified by management, and auditing the risk management processes across an organisation
- providing assurance on the management of risk
- providing active support and involvement in the risk management process

- facilitating risk identification/assessment and educating line staff in risk management and internal control
- co-coordinating risk reporting to the board, audit committee, etc In determining the most appropriate role for a particular organisation, Internal Audit should ensure that the professional requirements for independence and objectivity are not breached.

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9.7 CONCEPT OF PROBABILITY

The number of total losses of an insurer may vary from year to year. But insurers cannot collect or adjust premium after the losses occur; they have to arrive at the premium in advance to take care of losses which may occur in the future. Therefore they have to be in a position to predict or forecast future losses, as accurately as possible. This, they are able to do because of the 'law of probability'

This 'law' (which is also called the 'law of large numbers' or the 'law of averages') provides a good basis for forecasting future events. According to this law, he greater the number of instances considered and longer the period examined, the more probable it will be that past experience will be repeated in the future also. In other words, the law of probability enables the insurers to 'estimate or forecast future loss experience with greater reliability'. This law is valid only if the events being studied are random and not deliberately created.

CHECK YOUR PROGRESS
3. What is the concept of probability?

Thus it will be observed that with increase in the number of cases insured, the difference between the actual future losses and the estimated future losses becomes less and less. Thus, insurers are able to anticipate future losses more accurately and fix the rate of premium. This is the reason why it is said that for successful operation of the insurance business, a large number of risks should be available for insurance.

The law of probability is subject to the qualifications that conditions remain the same. Recent trends will have to be taken into account by insurers in adjusting the rate of premium suitably. Thus, fixing of premium rates not only calls for mathematical calculation based on past experience but also a great deal of judgement and foresight.

NOTES

9.8 RISK EVALUATION

Risk evaluation is concerned with assessing probability and impact of individual risks, taking into account any interdependencies or other factors outside the immediate scope under investigation:

- Probability is the evaluated likelihood of a particular outcome actually happening (including a consideration of the frequency with which the outcome may arise). For example, major damage to a building is relatively unlikely to happen, but would have enormous impact on business continuity. Conversely, occasional personal computer system failure is fairly likely to happen, but would not usually have a major impact on the business
- Impact is the evaluated effect or result of a particular outcome actually happening
- Impact should ideally be considered under the elements of:
  - time
  - quality
  - benefit
  - people/resource

Some risks, such as financial risk, can be evaluated in numerical terms.

Others, such as adverse publicity, can only be evaluated in subjective ways.

There is a need for some framework for categorising risks, for example, high, medium and low.

When considering a risk's probability, another aspect is when the risk might occur.

Some risks will be predicted to be further away in time than others and so attention can be focused on the more immediate ones.

This prediction is called the risk's proximity. The proximity of each risk should be included in the Risk Log.

9.9 VALUE AT RISK (VAR)

Value at risk (VAR or sometimes VaR) has been called the "new science of risk management", but you do not need to be a scientist to use VAR.

a) The Idea behind VAR:-

The most popular and traditional measure of risk is volatility. The main problem with volatility, however, is that it does not care about the direction of an investment's movement: a stock can be volatile because it suddenly jumps higher. Of course, investors are not distressed by gains! (See The Limits and Uses of Volatility.)

For investors, risk is about the odds of losing money, and VAR is based on that common-sense fact. By assuming investors care about the odds of a really big loss, VAR answers the question, "What is my worst-case scenario?" or "How much could I lose in a really bad month?"

Now let's get specific. A VAR statistic has three components: a time period, a confidence level and a loss amount (or loss percentage). Keep these three parts in mind as we give some examples of variations of the question that VAR answers:

- What is the most I can - with a 95% or 99% level of confidence - expect to lose in dollars over the next month?
- What is the maximum percentage I can - with 95% or 99% confidence - expect to lose over the next year?

You can see how the "VAR question" has three elements: a relatively high level of confidence (typically either 95% or 99%), a time period (a day, a month or a year) and an estimate of investment loss (expressed either in dollar or percentage terms).

b) Methods of Calculating VAR:-

Institutional investors use VAR to evaluate portfolio risk, but in this introduction we will use it to evaluate the risk of a single index that trades like a stock: the NASDAQ

NOTES

CHECK YOUR PROGRESS

4. What are the 3 methods of calculating VAR?

100 Index, which trades under the ticker QQQQ. The QQQQ is a very popular index of the largest non-financial stocks that trade on the NASDAQ exchange.

There are three methods of calculating VAR: the historical method, the variance-covariance method and the Monte

Carlo simulation.

1. Historical Method

The historical method simply re-organizes actual historical returns, putting them in order from worst to best. It then assumes that history will repeat itself, from a risk perspective.

2. The Variance-Covariance Method

This method assumes that stock returns are normally distributed. In other words, it requires that we estimate only two factors - an expected (or average) return and a standard deviation - which allow us to plot a normal distribution curve.

The idea behind the variance-covariance is similar to the ideas behind the historical method - except that we use the familiar curve instead of actual data. The advantage of the normal curve is that we automatically know where the worst 5% and 1% lie on the curve. They are a function of our desired confidence and the standard deviation (σ)

3. Monte Carlo Simulation

The third method involves developing a model for future stock price returns and running multiple hypothetical trials through the model. A Monte Carlo simulation refers to any method that randomly generates trials, but by itself does not tell us anything about the underlying methodology.

For most users, a Monte Carlo simulation amounts to a "black box" generator of random outcomes.

4. Summary:-

Value at Risk (VAR) calculates the maximum loss expected (or worst case scenario) on an investment, over a given time period and given a specified degree of confidence. We looked at three methods commonly used to calculate VAR. But keep in mind that two of our methods calculated a daily VAR and the third method calculated monthly VAR.

ANSWERS TO CHECK YOUR PROGRESS

NOTES

1. Four
2. 1. Heuristics and congnitive 2. Cultural theory 3. Social amplification of risk framework
3. Insurers cannot collect or adjust premium after the losses occur; they have to arrive at the premium in advance to take care of losses which may occur in the future.
4. 1, Historical Method

   2. The Variance – Covariance Method

   3. Monte Carlo Simulation

9.10. REVIEW QUESTIONS

a). Explain the concept of probability

b). Explain the concept of Value at Risk

c). What are the methods to calculate VAR?

d) What are the steps in Risk Management Process?

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UNIT 10

RISK MANAGEMENT METHODS

10.1.INTRODUCTION

A contingency plan is a plan devised for a specific situation when things could go wrong. Contingency plans are often devised by governments or businesses who want to be prepared for anything that could happen. They are sometimes known as "Back-up plans", "Worst-case scenario plans", "Scrap Situation" or "Plan B"

10.2 CONTINGENCY PLANNING

Contingency plans include specific strategies and actions to deal with specific variances to assumptions resulting in a particular problem, emergency or state of affairs. They also include a monitoring process and "triggers" for initiating planned actions. They are required to help governments, businesses or individuals to recover from serious incidents in the minimum time with minimum cost and disruption.

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Business and government contingency plans need to include planning for marketing to gain stakeholder support and understanding. Stakeholders need to be kept informed of the reasons for any changes, the vision of the end result and the proposed plan for getting there. The level of stakeholders' importance and influence should be considered when determining the amount of marketing required, the timescales for implementation and completion, and the overall effectiveness of the plan. If time permits, input and consultation from the most influential stakeholders should be incorporated into the building of any contingency plan as without acceptance from these people any plan will at best encounter limited success.

During times of crisis, contingency plans are often developed to explore and prepare for any eventuality. During the Cold war, many governments made contingency plans to protect themselves and their citizens from nuclear attack. Examples of contingency plans designed to inform citizens of how to survive a nuclear attack are the booklets Survival Under Atomic Attack, Protect and Survive, and Fallout Protection, which were issued by the British and American governments. Today there are still contingency plans in place to deal with terrorist attacks or other catastrophes.

CHECK YOUR PROGRESS

1. What is captive insurance?

10.3 CAPTIVE INSURANCE AGREEMENTS

Captive insurance is insurance or reinsurance provided by a company that is formed primarily to cover the assets and risks of its parent company or companies. Captive insurance is essentially an "in-house" insurance company with a limited purpose and is not available to the general public. It is an alternative form of risk management that is becoming a more practical and popular means through which companies can protect themselves financially while having more control over how they are insured.

Companies both large and small are having an increasingly difficult time finding and affording traditional insurance policies to cover their risks and assets. Premiums are increasing at a steady clip, making insurance coverage nearly cost prohibitive for most companies, leaving them vulnerable to catastrophic loss. Some companies have risks that are difficult or impossible to cover. Increasingly, traditional insurance companies are setting up their credit rating structures without considering actual loss experience, but

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rather, trends in the market, making it difficult for many companies to qualify for coverage. Another stumbling block for companies is that they might have insufficient credit for deductibles and exercise poor loss control, which in turn makes them ineligible for coverage.

There are five basic types of captive insurance. The first is the most prevalent, the Single Parent Captive, in which an insurance or reinsurance company is formed simply to insure the risk of a parent company or its affiliates, which are not insurance companies. The Association Captive is an insurance company which is formed and owned by an industry, trade or service group strictly for the benefit of its members. The Group Captive is owned by a group of companies and provides them with a captive insurance company for a shared insurance need.

An Agency Captive is a reinsurance company owned by a separate insurance company to reinsure their client's risks. Reinsurance is a type of insurance in which insurance companies share the burden of a catastrophic loss with other insurance companies, usually on a global basis. Put simply, an insurance company buys insurance to cover their own loss when their claims are devastatingly high. The last type of captive insurance is the Rent-A-Captive, which provides the benefits of a captive insurance company for a fee to small companies which may not have the resources to form their own captive insurance company.

The financial benefits of captive insurance are significant. Premiums tend to be lower simply because, with commercial insurance, premiums are padded to cover the insurance company's own profit margins and overhead costs. With captive insurance, companies are not attempting to make a profit, but simply to provide themselves with low cost insurance coverage. Captive insurance is more flexible than traditional insurance, because the company can adjust the proportion of assumption of risk or the amount of reinsurance depending on how soft or hard the market is.

Another benefit of captive insurance is in claims management. With "in-house" insurance, a company cuts through the red tape and bureaucracy associated with

traditional insurance companies. The parent company can dictate the procedure by which claims are processed. Perhaps one of the biggest benefits is that excess net premiums can be recouped by the parent company when claims are low, and they can increase reinsurance in riskier areas.

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Like traditional insurance, captive insurance can cover several types of risk. Captive insurance can underwrite public and product liability, physical property damage, professional indemnity, employee benefits such as medical aid and employer's liability.

CHECK YOUR PROGRESS

2. What is reinsurance?

10.4 REINSURANCE

Reinsurance is insurance that is purchased by an insurance company (insurer) from a reinsurer as a means of risk management, to transfer risk from the insurer to the reinsurer. The reinsurer and the insurer enter into a reinsurance agreement which details the conditions upon which the reinsurer would pay the insurer's losses (in terms of excess of loss or proportional to loss). The reinsurer is paid a reinsurance premium by the insurer, and the insurer issues thousands of policies.

For example, assume an insurer sells one thousand policies, each with a $1 million policy limit. Theoretically, the insurer could lose $1 million on each policy – totaling to $1 billion. It may be better to pass some potential risk to a reinsurance company (reinsurer) as this will minimize the insurer's risk.

There are two basic methods of reinsurance:

1. Facultative Reinsurance is specific reinsurance covering a single risk. The reinsurer is reinsuring one insured on a specific policy. Each facultative risk is submitted by the insurer to the reinsurer.

1. Treaty Reinsurance is a method of reinsurance requiring the insurer and the reinsurer to formulate and execute a reinsurance contract. The reinsurer then covers all the insurance policies coming within the scope of that contract. There are two basic methods of treaty reinsurance:

- Quota Share Treaty Reinsurance, and
- Excess of Loss Treaty Reinsurance.

NOTES

In the past 30 years there has been a major shift from Quota Share to Excess of Loss in the property and casualty fields.

Almost all insurance companies have a reinsurance program. The ultimate goal of that program is to reduce their exposure to loss by passing the exposure to loss to a reinsurer or a group of reinsurers. Therefore, they are 'transferring some of the risk to the reinsurer or a group of reinsurers'. Insurance, which is regulated at the state level (in the USA), permits an insurer only to issue policies with a maximum limit of 10% of their surplus (net worth), unless those policies are reinsured.

a) Risk transfer:-

With reinsurance, the insurer can issue policies with higher limits than it would otherwise be allowed, therefore, being permitted to take on more risk because some of that risk is now transferred to the reinsurer. Reinsurance has gone from a relatively unsophisticated business to a highly sophisticated endeavor. The reason for that is the number of reinsurers that suffered significant losses and became financially impaired. From 2000 onward, reinsurers have become much more reliant on actuarial models and tight review of the companies they are willing to reinsure. They would review their financials closely, look at the experience of the proposed business to be reinsured, review the underwriters that will write that business, review their rates, and much, much more. Almost all reinsurers now will visit the insurance company and review underwriting and claim files and more.

b) Income smoothing

Reinsurance can help to make an insurance company's results more predictable by absorbing larger losses and reducing the amount of capital needed to provide coverage. Furthermore, the risk factor is also diversified with the reinsurer bearing some of the loss incurred.

c) Surplus relief

An insurance company's writings are limited by its balance sheet (this test is known as the solvency margin). When that limit is reached, an insurer can do one of the following: stop writing new business, increase its capital, or buy "surplus relief" reinsurance. Buying reinsurance is usually done on a quota share basis and is an efficient way of not having to turn clients away or raise additional capital.

d) Arbitrage

The insurance company may be motivated by arbitrage in purchasing reinsurance coverage at a lower rate than they charge the insured for the underlying risk, which can be in the area of risk associated with any form of the asset that is being issued or loaned against. It can be a car, a mortgage, an insurance (personal, fire, business, etc.) and alike.

In general, the reinsurer may be able to cover the risk at a lower premium than the insurer because:

- The reinsurer may have some intrinsic cost advantage due to economies of scale or some other efficiency
- Reinsurers may operate under weaker regulation than their clients. This enables them to use less capital to cover any risk, and to make less prudent assumptions when valuing the risk.
- Even if the regulatory standards are the same, the reinsurer may be able to hold smaller actuarial reserves than the cedant if it thinks the premiums charged by the cedant are excessively prudent.
- The reinsurer may have a more diverse portfolio of assets and especially liabilities than the cedant. This may create opportunities for hedging that the cedant could not exploit alone. Depending on the regulations imposed on the reinsurer, this may mean they can hold fewer assets to cover the risk.
- The reinsurer may have a greater risk appetite than the insurer.

e) Reinsurer's expertise

The insurance company may want to avail of the expertise of a reinsurer in regard to a specific (specialised) risk or want to avail of their rating ability in odd risks.

f) Creating a manageable and profitable portfolio of insured risks

By choosing a particular type of reinsurance method, the insurance company may be able to create a more balanced and homogenous portfolio of insured risks. This would lend greater predictability to the portfolio results on net basis (after reinsurance) and would be reflected in income smoothing. While income smoothing is one of the objectives of reinsurance arrangements, the mechanism is by way of balancing the portfolio.

g) Managing cost of capital for an insurance company

By getting a suitable reinsurance, the insurance company may be able to substitute "capital needed" as per the requirements of the regulator for premium written. It could happen that the writing of insurance business requires x amount of capital with y% of cost of capital and reinsurance cost is less than x*y%. Thus more unpredictable or less frequent the likelihood of an insured loss, more profitable it can be for an insurance company to seek reinsurance.

h) Types

1 Proportional

Proportional reinsurance (the types of which are quota share and surplus reinsurance) involves one or more reinsurers taking a stated percent share of each policy that an insurer produces ("writes"). This means that the reinsurer will receive that stated percentage of each dollar of premiums and will pay that percentage of each dollar of losses. In addition, the reinsurer will allow a "ceding commission" to the insurer to compensate the insurer for the costs of writing and administering the business (agents' commissions, modeling, paperwork, etc.).

The insurer may seek such coverage for several reasons. First, the insurer may not have sufficient capital to prudently retain all of the exposure that it is capable of producing. For example, it may only be able to offer $1 million in coverage, but by purchasing proportional reinsurance it might double or triple that limit. Premiums and losses are then shared on a pro rata basis. For example, an insurance company might purchase a 50% quota share treaty; in this case they would share half of all premium and losses with the reinsurer. In a 75% quota share, they would share (cede) 3/4 of all premiums and losses.

The other form of proportional reinsurance is surplus share or surplus of line treaty. In this case, a retained "line" is defined as the ceding company's retention - say $100,000. In a 9 line surplus treaty the reinsurer would then accept up to $900,000 (9 lines). So if the insurance company issues a policy for $100,000, they would keep all of the premiums and losses from that policy. If they issue a $200,000 policy, they would give (cede) half of the premiums and losses to the reinsurer (1 line each). The maximum underwriting capacity of the cedant would be $ 1,000,000 in this example. Surplus treaties are also known as variable quota shares.

2 Non-proportional

Non-proportional reinsurance only responds if the loss suffered by the insurer exceeds a certain amount, which is called the "retention" or "priority." An example of this form of reinsurance is where the insurer is prepared to accept a loss of $1 million for any loss which may occur and they purchase a layer of reinsurance of $4 million in excess of $1 million. If a loss of $3 million occurs, then insurer will retain $1 million and will recover $2 million from its reinsurer(s). In this example, the reinsured will retain any loss exceeding $5 million unless they have purchased a further excess layer (second layer) of say $10 million excess of $5 million.

The main forms of non-proportional reinsurance are excess of loss and stop loss.

Excess of loss reinsurance can have three forms - "Per Risk XL" (Working XL), "Per Occurrence or Per Event XL" (Catastrophe or Cat XL), and "Aggregate XL". In per risk, the cedant's insurance policy limits are greater than the reinsurance retention. For example, an insurance company might insure commercial property risks with policy limits up to $10 million, and then buy per risk reinsurance of $5 million in excess of $5 million. In this case a loss of $6 million on that policy will result in the recovery of $1 million from the reinsurer.

In catastrophe excess of loss, the cedant's per risk retention is usually less than the cat reinsurance retention (this is not important as these contracts usually contain a 2 risk warranty i.e. they are designed to protect the reinsured against catastrophic events that involve more than 1 policy). For example, an insurance company issues homeowner's policies with limits of up to $500,000 and then buys catastrophe reinsurance of $22,000,000 in excess of $3,000,000. In that case, the insurance company would only

recover from reinsurers in the event of multiple policy losses in one event (i.e., hurricane, earthquake, flood, etc.).

Aggregate XL affords a frequency protection to the reinsured. For instance if the company retains $1 million net any one vessel, the cover $10 million in the aggregate excess $5 million in the aggregate would equate to 10 total losses in excess of 5 total losses (or more partial losses). Aggregate covers can also be linked to the cedant's gross premium income during a 12 month period, with limit and deductible expressed as percentages and amounts. Such covers are then known as "Stop Loss" or annual aggregate XL.

i) Risk-attaching basis

A basis under which reinsurance is provided for claims arising from policies commencing during the period to which the reinsurance relates. The insurer knows there is coverage for the whole policy period when written.

All claims from cedant underlying policies incepting during the period of the reinsurance contract are covered even if they occur after the expiration date of the reinsurance contract. Any claims from cedant underlying policies incepting outside the period of the reinsurance contract are not covered even if they occur during the period of the reinsurance contract.

j) Loss-occurring basis

A Reinsurance treaty from under which all claims occurring during the period of the contract, irrespective of when the underlying policies incepted, are covered. Any claims occurring after the contract expiration date are not covered.

As opposed to claims-made policy. Insurance coverage is provided for losses occurring in the defined period. This is the usual basis of cover for most policies.

k) Claims-made basis

A policy which covers all claims reported to an insurer within the policy period irrespective of when they occurred.

l) Contracts

Most of the above examples concern reinsurance contracts that cover more than one policy (treaty). Reinsurance can also be purchased on a per policy basis, in which case it is known as facultative reinsurance. Facultative reinsurance can be written on either a

quota share or excess of loss basis. Facultative reinsurance is commonly used for large or unusual risks that do not fit within standard reinsurance treaties due to their exclusions. The term of a facultative agreement coincides with the term of the policy. Facultative reinsurance is usually purchased by the insurance underwriter who underwrote the original insurance policy, whereas treaty reinsurance is typically purchased by a senior executive at the insurance company.

Reinsurance treaties can either be written on a "continuous" or "term" basis. A continuous contract continues indefinitely, but generally has a "notice" period whereby either party can give its intent to cancel or amend the treaty within 90 days. reinsurers to have long term relationships that span many years.

m) Catastrophe cover:-

Catastrophe Reinsurance A form of excess of loss reinsurance which, subject to a specified limit, indemnifies the reinsured company for the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events. The actual reinsurance document is referred to as "a catastrophe cover."

10.5. REINSURANCE MARKETS

Most reinsurance placements are not placed with a single reinsurer but are shared between a number of reinsurers. For example a $30,000,000 excess of $20,000,000 layer may be shared by 30 or more reinsurers. The reinsurer who sets the terms (premium and contract conditions) for the reinsurance contract is called the lead reinsurer; the other companies subscribing to the contract are called following reinsurers.

About half of all reinsurance is handled by reinsurance brokers who then place business with reinsurance companies. The other half is with "direct writing" reinsurers who have their own production staff and thus reinsure insurance companies directly. In Europe reinsurers write both direct and brokered accounts.

Using game-theoretic modeling, Professors Michael R. Powers (Temple University) and Martin Shubik (Yale University) have argued that the number of active reinsurers in a given national market should be approximately equal to the square-root of

the number of primary insurers active in the same market. Econometric analysis has provided empirical support for the Powers-Shubik rule.

NOTES

Insurers (that is to say, reinsureds) tend to choose their reinsurers with great care as they are exchanging insurance risk for credit risk. Risk managers monitor reinsurers' financial ratings (S&P, A.M. Best, etc.) and aggregated exposures regularly.

CHECK YOUR PROGRESS

3. What is retrocession?

10.6 RETROCESSION

Reinsurance companies themselves also purchase reinsurance, a practice known as a retrocession. They purchase this reinsurance from other reinsurance companies. A reinsurance company that sells reinsurance is a "retrocessionaire". A reinsurance company that buys reinsurance is a "retrocedent".

It is not unusual for a reinsurer to buy reinsurance protection from other reinsurers. For example, a reinsurer that provides proportional, or pro rata, reinsurance capacity to insurance companies may wish to protect its own exposure to catastrophes by buying excess of loss protection. Another situation would be that a reinsurer which provides excess of loss reinsurance protection may wish to protect itself against an accumulation of losses in different branches of business which may all become affected by the same catastrophe. This may happen when a windstorm causes damage to property, automobiles, boats, aircraft and loss of life, for example.

This process can sometimes continue until the original reinsurance company unknowingly gets some of its own business (and therefore its own liabilities) back. This is known as a "spiral" and was common in some specialty lines of business such as marine and aviation. Sophisticated reinsurance companies are aware of this danger and through careful underwriting attempt to avoid it.

In the 1980s, the London market was badly affected by the creation of reinsurance spirals. This resulted in the same loss going around the market thereby artificially inflating market loss figures of big claims (such as the Piper Alpha oil rig). The LMX

spiral (as it was called) has been stopped by excluding retrocessional business from reinsurance covers protecting direct insurance accounts.

NOTES

It is important to note that the insurance company is obliged to indemnify its policyholder for the loss under the insurance policy whether or not the reinsurer reimburses the insurer. Many insurance companies have experienced difficulties by purchasing reinsurance from companies that did not or could not pay their share of the loss. (These unpaid claims are known as uncollectibles.) This is particularly important on long-tail lines of business where the claims may arise many years after the premium is paid.

10.7 LLOYDS MARKETS

Lloyd's, also known as Lloyd's of London, is a British insurance and reinsurance market. It serves as a meeting place where multiple financial backers, underwriters, or members, whether individuals (traditionally known as Names) or corporations, come together to pool and spread risk. Unlike most of its competitors in the insurance and reinsurance industry, it is not a company. The Society of Lloyd's was incorporated by the Lloyd's Act 1871.

1 Formation

The market began in Edward Lloyd's coffeehouse around 1688 in Tower Street, London. His establishment was a popular place for sailors, merchants, and ship owners, and Lloyd catered to them with reliable shipping news. The shipping industry community frequented the place to discuss insurance deals among themselves. Just after Christmas 1691, the coffee shop relocated to Lombard Street (a blue plaque commemorates this location). This arrangement carried on until 1774, long after Lloyd's death in 1713, when the participating members of the insurance arrangement formed a committee and moved to the Royal Exchange as The Society of Lloyd's.

2 Structure

Lloyd's is not an insurance company. It is an insurance market of members. As the oldest continuously active insurance marketplace in the world, Lloyd's has retained some unusual structures and practices that differ from all other insurance providers today. Originally created as an unincorporated association of subscribing members in 1774, it was incorporated by the Lloyd's Act 1871, and it is currently governed under the Lloyd's Acts of 1871 through to 1982.

Lloyd's itself does not underwrite insurance business, leaving that to its members (see below). Instead the Society operates effectively as a market regulator, setting rules under which members operate and offering centralized administrative services to those members.

3 Businesses at Lloyd's

There are two classes of people and firms active at Lloyd's. The first are members or providers of capital. The second are agents, brokers, and other professionals who support the members, underwrite the risks, and represent outside customers (for example, individuals and companies seeking insurance and insurance companies seeking reinsurance).

4 Members

For most of Lloyd's history, rich individuals (Names) backed policies written at Lloyd's with all of their personal wealth (unlimited liability). Since 1994, Lloyd's has allowed corporate members into the market, with limited liability. The losses in the early 1990s devastated the finances of many Names (upwards of 1,500 out of 34,000 (4.4%) Names were declared bankrupt) and scared away others. Today, individual Names provide only 10% of capacity at Lloyd's, with corporations accounting for the rest. No new Names with unlimited liability are admitted, and the importance of individual Names will continue to decline as they slowly withdraw, convert (generally, now, into Limited Liability Partnerships) or die.

5 Managing agents

Managing agents sponsor and manage syndicates. They canvas members for commitments of capacity, create the syndicate, hire underwriters, and oversee all of the syndicate's activities. Managing agents may run more than one syndicate.

6 Members' agents

Members' agents coordinate the members' underwriting and act as a buffer between Lloyd's, the managing agents and the members. They were introduced in the mid 1970s and grew in number until many went bust; many of the businesses merged, and there are now only four left (Argenta, Hampden, Alpha and LMAS, which has no active Names). It is mandatory that unlimited Names write through a members' agent, and many limited liability members choose to do so.

Recent results have benefited from tougher underwriting standards imposed by the Franchise Board and improved terms and conditions following widespread underwriting losses during the period 1998 to 2001, the attack on the World Trade Center on September 11, 2001, and large hurricane-related property and energy claims in both 2004 and 2005.

7 Lloyd's brokers

Outsiders, whether individuals or other insurance companies, cannot do business directly with Lloyd's syndicates. They must hire Lloyd's brokers, who are the only customer-facing companies at Lloyd's. They are therefore often referred to as 'intermediaries'. Lloyd's brokers shop customers' policies among the syndicates, trying to obtain the best prices and terms.

8 Integrated Lloyd's vehicles (ILVs)

When corporations became admitted as Lloyd's members, they did not like the traditional structure. Insurance companies did not want to rely on the underwriting skills of syndicates they did not control, so they started their own. An integrated Lloyd's vehicle is a group of companies that combines a corporate member, a managing agent, and a syndicate under common ownership. Some ILVs allow minority contributions from other members, but most now try to operate on an exclusive basis.

NOTES

9 Market structure

As of 31 January 2009, Lloyd's of London had the following structure:[6]

- Capital providers
  - 1,238 corporate members
  - 773 individual Names with unlimited liability
- Market participants
  - 51 managing agents
  - 87 syndicates
  - 176 Lloyd's brokers (as of January 2008)

Lloyd's is not publicly traded, though some of its members are listed companies, such as Hiscox Ltd., Catlin Group Limited and Hardy Underwriting Bermuda Ltd.

10 Types of policies

Lloyd's syndicates write a diverse range of policies, both direct insurance and reinsurance, covering property, motor, liability, marine, aviation, catastrophe and many other risks. Lloyd's has a unique niche in unusual, specialist business such as kidnap and ransom insurance, fine art insurance, aviation insurance, marine, etc.

10.8 ANSWERS TO CHECK YOUR PROGRESS

1. Captive insurance is insurance or reinsurance provided by a company that is formed primarily to cover the assets and risks of its parent company or companies
2. Reinsurance is insurance that is purchased by an insurance company (insurer) from a reinsurer as a means of risk management, to transfer risk from the insurer to the reinsurer
3. Reinsurance companies themselves also purchase reinsurance, a practice known as a retrocession. They purchase this reinsurance from other reinsurance companies.

10.9. REVIEW QUESTIONS

a). What is Contingency Planning?

b). What are Captive Insurance Agreements?

c). What is Reinsurance?

d). What are Reinsurance Markets?

e). What is Lloyd's Market?